TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1957

No. 306

THE COLONY, INC., PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED JULY 22, 1957

CERTIORARI GRANTED OCTOBER 14, 1957

SUPREME COURT OF THE UNITED STATES

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RECORD PRESS, PRINTERS, NEW YORK, N. Y., JANUARY 24, 1958

[fol. 1]

BEFORE THE TAX COURT OF THE UNITED STATES

THE COLONY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

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26 T. C. No. 3

Docket No. 53681—Filed April 9, 1956.

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1. The petitioner is a corporation organized to acquire, subdivide, and sell real estate. It was organized with a total capital of $1,000. It obtained bank loans, secured by liens on its real estate, in an amount in excess of $149,000. Five of petitioner's stockholders paid over a total of $57,800 to petitioner and received petitioner's interest-bearing promissory notes in that amount. *Held,* the $57,800 paid over to petitioner by its stockholders constituted contributions to capital, rather than bona fide loans, and amounts paid by petitioner to the stockholders in 1948, 1949, and 1950, constituted nondeductible distributions in the nature of dividends, rather than interest on indebtedness which is deductible under section 23(b) of the 1939 Code.

2. In determining its basis for gain or loss in the subdivision lots which it sold in 1946, 1947, and 1950, the petitioner added to its cost of the lots a pro rata portion of improvement expenses which it incurred or estimated that it would incur in developing the subdivision. *Held,* the cost of a water supply system which petitioner continued to own and operate during the taxable years did not constitute a development expense which could be added to petitioner's basis in the subdivision lots; *held, further,* petitioner's basis in the subdivision lots includes the amount of payments made by petitioner to two utility companies to induce the latter to extend their services to petitioner's subdivision; *held, further,* the respondent's determination

that petitioner overestimated its development expenses in the amount of $5,550.82 is sustained.

3. For the taxable years ended October 31, 1946, and October 31, 1947, the petitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the gross income stated in its returns. [fol. 2] The understatements of gross income resulted from overstatements of cost of goods sold, rather than from omissions of gross receipts. *Held*, the 5-year statute of limitations contained in section 275(c) of the 1939 Code is applicable, and the deficiencies determined for the years ended October 31, 1946, and October 31, 1947, are not barred. *Estate of J. W. Gibbs, Sr.*, 21 T. C. 443, followed.

Andrew W. Duncan, Esq., and *Don S. Sturgill, Esq.*, for the petitioner.

James F. Shea, Esq., for the respondent.

The Commissioner determined deficiencies in income tax and excess-profits tax as follows:

Year ended October 31	Income Tax	Excess-Profits Tax
1946	$7,988.72	$2,356.71
1947	1,194.29	—
1948	987.31	—
1950	224.23	—

The year ended October 31, 1949, also is involved because the amount of net operating loss sustained in that year will determine the amount of net operating loss deduction allowable for the year ended October 31, 1947. The issues to be decided are (1) whether payments made by petitioner to its shareholders in the amounts of $8,988.41, $3,468, and $3,468, in the taxable years ended October 31, 1948, 1949, and 1950, respectively, were deductible by petitioner as interest payments, or whether such payments were non-deductible distributions in the nature of dividends; (2) whether petitioner's cost of subdivision lots includes the expenditures made to construct a water supply for the subdivision and the payments made to public utilities in order to induce the utilities to extend their service to the subdivision; and (3) whether the deficiencies determined

for the years ended October 31, 1946, and October 31, 1947, are barred by the statute of limitation.

[fol. 3] FINDINGS OF FACT

The petitioner is a corporation organized under the laws of the State of Kentucky. Petitioner kept its books and filed its returns on an accrual method for fiscal years ended October 31. Petitioner's returns for the taxable years were filed with the collector for the district of Kentucky.

The petitioner's principal business is the development and sale of lots in a subdivision called "The Colony," which is located outside the city limits of Lexington, Kentucky. The petitioner also owned a water supply and distribution system, and beginning in 1949, sold water to houses which were built in the subdivision.

Deduction of Payments to Stockholders

The petitioner was incorporated on or about November 14, 1945. Its authorized capital stock, which was all issued, consisted of 400 shares of capital stock without par value. Its paid-in capital was $1,000, or $2.50 per share of capital stock.

On or about April 19, 1946, Hugh Meriwether, L. J. Blakely, and Charles Sturgill, as owners of all of the petitioner's stock, entered into an agreement with Dr. Halbert Leet. The agreement recited that Dr. Leet agreed to lend petitioner, on petitioner's note, the sum of $17,500 for 5 years with interest at 6 per cent, payable semi-annually; that Meriwether, Blakely, and Sturgill agreed that they would convey to Dr. Leet, without further consideration, 10 per cent of petitioner's stock, that is, 40 shares; and that no dividends would be paid by petitioner without Dr. Leet's consent until the note was paid. The agreement between Dr. Leet and petitioner's shareholders provides, in part, as follows:

> This memorandum of agreement between Hugh Meriwether, L. J. Blakely and Charles Sturgill, of Lexington, Ky., owners of the capital stock of the Kentucky corporation The Colony, parties of the first [fol. 4] part, hereinafter called the "Stockholders," and

Dr. Halbert Leet, of Lexington, Ky., party of the second part, hereinafter called "Dr. Leet," witnesseth that it is agreed by and between the parties hereto as follows:

Dr. Leet shall lend to the said corporation, The Colony on or before the 25th day of April, 1946, the sum of Seventeen Thousand Five Hundred Dollars ($17,500.00) upon the latter's negotiable promissory note in the said sum of money to be dated the day said loan is made, and to be payable on or before five years after date, with interest thereon at the rate of 6% per annum, payable semi-annually, from its date until its payment.

The Stockholders shall, at the same time with the making of said loan, cause the said corporation to execute and deliver said note to Dr. Leet, and will assign and transfer to Dr. Leet as his own, without further consideration, ten per cent (10%) of the capital stock of said corporation: and they, and their successors, if any, in the ownership of their respective shares of stock of said corporation, shall see to it that no dividend is paid by said corporation, (except with the consent of Dr. Leet or his successors in ownership of said 10% of the stock) until said note (and any similar note issued or to be issued by the corporation under similar circumstances) shall have been paid.

On April 24, 1946, Dr. Leet paid $17,500 to petitioner in exchange for its note, and received 40 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. On the same day, L. B. Shouse also paid $17,500 to petitioner in exchange for its note, and received 40 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. Also, on the same day, Meriwether, Blakely, and Sturgill each paid $7,600 to petitioner in exchange for similar promissory notes. The total amount received by petitioner on April 24, 1946, from the five individuals in exchange for its notes was $57,800. The notes issued by petitioner stated that

repayment was to be made in 5 years, that is, on April 24, 1951, and that interest was payable at the rate of 6 per cent.

Prior to the end of petitioner's first fiscal year, on October 31, 1946, petitioner also issued notes in the amount of [fol. 5] $149,403 to banks. The notes held by the banks were secured by liens on petitioner's real estate.

Also, prior to October 31, 1946, Gilmore N. Nunn acquired 4 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. On October 31, 1946, petitioner's stock and notes payable were held as follows:

Name	Shares of petitioner's stock	Investment in stock at $2.50 per share	Face amount of petitioner's notes
Hugh Meriwether	105⅓	$ 263.34	$ 7,600
L. J. Blakely	105⅓	263.33	7,600
Charles Sturgill	105⅓	263.33	7,600
Dr. Halbert Leet	40	100.00	17,500
L. B. Shouse	40	100.00	17,500
Gilmore N. Nunn	4	10.00	—
Total—Shareholders only	400	$1,000.00	$ 57,800
Banks	—	—	149,403
Total	400	$1,000.00	$207,203

The notes described above are reflected in the balance sheet attached to petitioner's return for the year ended October 31, 1946, as "Notes Payable-Bank Loans" in the amount of $149,403, and "Notes Payable-Stockholders" in the amount of $57,800.

None of the notes held by the stockholders has been paid by the petitioner with the exception of the note in the face amount of $17,500 issued to L. B. Shouse. At the time this note was paid, petitioner also purchased Shouse's 40 shares of stock at a price of $2.50 per share, or a total of $100. Sometime after the taxable years, in 1953, Sturgill and the Central Rock Company, a corporation, acquired the stock and notes of petitioner held by the remaining stockholders, namely, Meriwether, Blakely, Dr. Leet, and Nunn. Sturgill and the Central Rock Company now own, equally, all of

petitioner's outstanding stock, and the notes in the face amount of $40,300 which remain outstanding.

[fol. 6] In the taxable years ended October 31, 1946, and October 31, 1947, the petitioner did not pay to the holders, or accrue on its books, or claim deductions on its returns for, any amounts payable as interest on the notes held by its stockholders. In the taxable year ended October 31, 1948, the petitioner paid a total of $8,988.41 to the 5 stockholder-noteholders, and claimed a deduction in that amount in its return for interest paid. The total amount of $8,988.41 purportedly was distributed in payment of the interest due on the notes for the three years ended October 31, 1946, 1947, and 1948, as follows:

Payments for years ended October 31

Name	1946	1947	1948	Total Paid
Leet	$ 525.00	$1,081.50*	$1,114.90*	$2,721.40
Shouse	525.00	1,081.50*	1,114.90*	2,721.40
Blakely	228.00	469.68*	484.19*	1,181.87
Meriwether	228.00	469.68*	484.19*	1,181.87
Sturgill	228.00	469.68*	484.19*	1,181.87
Totals	$1,734.00	$3,572.04	$3,682.37	$8,988.41

* Six per cent interest on $17,500, the face amount of the notes held by Leet and Shouse, is $1,050 per year. Six per cent interest on $7,600, the face amount of the notes held by Blakely, Meriwether, and Sturgill, is $456.00. The difference between these amounts and the somewhat larger amounts actually paid, as set forth above, is not explained in the record.

In each of the taxable years ended October 31, 1949, and October 31, 1950, the petitioner paid $3,468 to the 5 stockholder-noteholders, and claimed deductions in that amount in its returns for each of the years for interest paid.

The respondent disallowed the entire amount claimed by petitioner as interest deductions in its returns for the taxable years ended October 31, 1948, 1949, and 1950. The deficiency notice contains the following explanation for the disallowance of the interest deduction claimed in petitioner's return for the year ended October 31, 1948:

[fol. 7] It is held that the amount of $8,988.41 deducted as interest in the return filed for the fiscal year ended October 31, 1948, constitutes dividends within the purview of Section 115 of the Internal Revenue Code, and is therefore not allowable as a deduction in computing net taxable income.

Similar explanations are given for the disallowance of the interest deductions claimed in the returns for the years ended October 31, 1949, and October 31, 1950.

Except for items representing the notes payable to stockholders and to banks, and reserve accounts for depreciation and for improvements, the following are the only liabilities set forth in the balance sheets attached to petitioner's returns for the years ended October 31, 1946, to October 31, 1950, inclusive:

	Year Ended October 31				
	1946	1947	1948	1949	1950
Accounts Payable	$ 165.65	—	—	—	—
Accrued Taxes	5,160.09	$1,000.43	$4,033.84	$986.94	$1,004.48
Total	$5,325.74	$1,000.43	$4,033.84	$986.94	$1,004.48

The $57,800 paid to petitioner by the 5 shareholders in 1946 in return for petitioner's promissory notes constituted contributions to petitioner's capital rather than bona fide loans. The payments in the fiscal years ended October 31, 1948, 1949, and 1950, to the 5 stockholder-noteholders in the amounts of $8,988.41, $3,468, and $3,468, respectively did not represent payments of interest.

Cost of Subdivision Lots to Petitioner

Issue 2: Shortly after its organization, petitioner acquired a farm near Lexington, Kentucky. The farm was approximately 228 acres in size, and was acquired by petitioner for the purpose of subdivision into residential lots. The petitioner's plan of operation was to sell lots to indi-

vidual buyers, rather than to construct and sell homes. The petitioner sold lots in each of the years ended October 31, 1946, 1947, and 1950.

[fol. 8] For the purposes of reporting gain from the sale of lots, petitioner included as part of its cost or other basis in the lots a proportionate part of the estimated cost of developing the subdivision. The amount of estimated development expenses added by petitioner to its cost of the lots was $93,074.61, and the total basis claimed by petitioner in the subdivision amounted to $131,550. As is more fully set forth hereinafter, the respondent determined that the amount of development costs which were includible in the computation of petitioner's cost or other basis in the lots did not exceed $44,988.55, and that petitioner's total basis in the subdivision did not exceed $83,463.94. The amount of development expenses claimed by petitioner which was disallowed by respondent, $48,086.06, represents the following three items: The portion of the original estimated cost of development, $93,074.61, which petitioner had not expended as of September 30, 1950; the expenditures made by petitioner to acquire a water supply system; and the amount of payments made by petitioner to two utility companies. The amount of each of the three items is as follows:

Unexpended part of estimated development costs	$ 5,590.82
Expenditures for water supply system	33,781.70
Payments to utility companies	8,713.54
Total	$48,086.06

The first part of petitioner's real estate to be subdivided was The Colony, which comprised about 65 lots covering approximately 60 acres. When subdivision of The Colony began, there was no available source of water. Without water, the lots would not have been saleable. The petitioner was advised that it would cost between $40,000 to $60,000, and perhaps more, to connect The Colony with the facilities of the Lexington Water Company, which were approximately 1½ miles away. The petitioner's stockholders decided that petitioner would construct a water system to provide water to lot purchasers instead of entering into any

arrangement with the Lexington Water Company. Prior [fol. 9] to 1949, the petitioner completed a water supply and distribution system for The Colony. The chief source of water for the system is a well capable of producing 576,000 gallons of water each 24 hours. Water from the well is pumped automatically by turbine pump through a chlorination tank to a 55,000-gallon capacity concrete pool, and then, by highlift pumps, into a 3,000-gallon capacity steel pneumatic tank. For convenience, the portion of the water system described above is referred to as the "pumping system." From the pneumatic tank, the water passes into the "distribution system," which consists of 6,500 feet of 4- and 6-inch pipe, about 2,500 feet of 2-inch pipe, and meters to the various houses.

In a brochure put out by petitioner, the water system is described as follows:

> In order to provide fire protection and to supply home owners in The Colony, with pure, soft water, The Colony will have its own private water works. The chief source is a well which is now producing 576,000 gallons of pure water each twenty-four hours, sufficient for the normal use of 14,000 people. Water will be supplied to home owners from a 55,000-gallon concrete reservoir. The water supply will at all times be under the supervision of the State and County Boards of Health.

The water system constructed by the petitioner was intended to supply 20 houses to be located near The Colony, as well as the houses located in The Colony subdivision. Also, during the taxable year ended October 31, 1948, the petitioner sold an additional 40 acres of land from the original farm tract. The 40 acres were sold at public auction, and in order to induce purchasers to pay a higher price, the petitioner agreed to provide water for the land.

The total cost incurred by petitioner in constructing the water supply system was $33,781.70, as follows:

[fol. 10]	Pumping System	$16,528.12
	Distribution System	13,885.31
	Engineering fees	2,864.18
	Unclassified	504.09
	Total	$33,781.70

The petitioner retained easements over lots which it sold in The Colony. These easements reserved to petitioner the right to maintain its water distribution system on the lots, but did not obligate petitioner to do so.

The water supply system began operation sometime during the taxable year ended October 31, 1949. Water meters installed by petitioner measured the water supplied to the houses served by the water distribution system, and petitioner was paid by the consumers for the water it provided. In the taxable years ended October 31, 1949, to October 31, 1954, inclusive, petitioner realized, from the operation of its water supply system, the following amounts of gross receipts and profit or loss, the profit or loss being computed without deductions for electricity expense or depreciation:

Year ended October 31	Gross receipts	Net profit (or loss) before deduction for electricity or depreciation
1949	$211.89	$(249.71)
1950	583.12	155.99
1951	258.08	(182.12)
1952	350.38	(382.39)
1953	421.37	(260.61)
1954	408.59	(183.96)

The largest item of expense incurred by the petitioner in the operation of the water system was for wages. L. J. Blakely, who lived near the pump site, was paid $300 per year to "look after" the water system in the years ending October 31, 1949, 1950, and 1951; $440 in the year ended October 31, 1952; $480 in the year ended October 31, 1953; and $400 in the year ended October 31, 1954.

[fol. 11] The number of houses to which petitioner supplied water in each of the years set forth above is not shown in the record before us.

Throughout the taxable years and thereafter, the petitioner retained full ownership and control of the assets comprising the water supply system.

In 1948 and 1949, petitioner made payments to the Kentucky Utilities Company (hereinafter called Utilities Company) and the Central Kentucky Natural Gas Company (hereinafter called Gas Company), pursuant to agreements between petitioner and the companies relating to the exten-

sion of gas and electricity service to The Colony. Petitioner's contract with the Gas Company was dated October 16, 1946. Petitioner entered into two contracts with the Utilities Company, one dated December 17, 1947, and the other dated December 1, 1949. The total payments made by petitioner to the two companies under the contracts amounted to $8,713.54, as follows:

Payee	Date of Payment	Amount of Payment
Gas Company	January 6, 1948	$6,535.00
Utilities Co.	March 19, 1948	1,427.93
" "	December 17, 1949	750.61
	Total	$8,713.54

The payments made by petitioner were required by the companies before the latter would extend their services to The Colony. The contracts between petitioner and the companies provided that all or a part of the payments might be refunded to petitioner. For example, the contract with the Gas Company provided that the latter would refund to petitioner a total of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from date of the contract, that is, after October 16, 1956. Each of the contracts with the Utilities Company provided for the refund of approximately $160 to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions pro-
[fol. 12] vided for in the contracts. Exhibits 16 and 17 are incorporated by this reference. Up to the date of the hearing of this proceeding, the petitioner had received refunds of $1,407.41 from the Utilities Company and $750 from the Gas Company, or a total of $2,157.41, as follows:

Date of Refund	Refunds from Utilities Co.	Refunds from Gas Co.
Nov. 9, 1948	$162.27	$150
May 23, 1949	162.27	—
May 28, 1949	—	150
1951	491.49	450
1954	591.38	—
Totals	$1,407.41	$750

An account titled "Reserve for Improvements" was set up on petitioner's books and credited on September 30, 1946, in the amount of $93,074.61. This amount represented petitioner's estimate of the costs which would be incurred in the development of The Colony, and petitioner added a pro rata portion of this amount to its cost of each of the lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950.

The reserve account was debited in the amount of each expenditure which petitioner considered an expense of development for the subdivision. As of September 30, 1950, the total amount debited to the reserve account was $87,-483.79, and on that date there remained, from the original credit entry of $93,074.61, a credit balance of $5,590.82. The total amount debited to the reserve account, $87,483.79, consisted of the following entries: $33,781.70, the cost of the water supply system; $8,713.54, the total of the payments made to the utility companies; and $44,988.55 for other expenditures which are not in issue.

For the purpose of computing gain from the sale of the lots which were sold in 1946, 1947, and 1950, the petitioner added a proportionate part of $93,074.61, the amount originally credited to the reserve account for improvements to its cost of the lots sold. In its returns for the years ending [fol. 13] October 31, 1946, 1947, and 1950, petitioner reported gain from the sale of lots and gross income, as follows:

	Year ended October 31		
	1946	1947	1950
Selling Price of Lots	$78,987.50	$28,075.00	$8,000.00
Less Cost of Lots Sold	57,375.00	18,575.00	7,500.00
Gross profit on sale of lots	$21,612.50	$ 9,500.00	$ 500.00
Other income	637.53	8,595.41	8,909.25
Gross income reported	$22,250.03	$18,095.41	$9,409.25

The respondent determined that the development costs which might be added to petitioner's cost of the lots did not exceed $44,988.55. Accordingly, the respondent determined that petitioner had overstated its cost of the lots in

the total amount of $48,086.06, which is the difference between the estimated development costs claimed by petitioner, $93,074.61, and $44,988.55, the amount determined by respondent. The respondent also determined that petitioner overstated the costs of lots sold and understated the profit from lot sales in the years ended October 31, 1946, 1947, and 1950, in the amounts of $20,972.54, $6,789.80, and $2,741.51, respectively. The amount of the adjustment in each of these years is the portion of the total overstatement of cost determined by respondent, $48,086.06, which is allocable to the lots sold in each year. The method used by respondent to redetermine petitioner's cost of the lots sold in each year is as follows: The petitioner claimed a basis of $131,550 in the entire subdivision, after adding in the amount of $93,074.61 for the estimated cost of improvements. The respondent determined that petitioner overstated its basis in the amount of $48,086.06, and that the petitioner's basis did not exceed $83,463.94. The basis determined by respondent, $83,463.94, amounted to 63.44655 per cent of the basis reported by petitioner. Accordingly, respondent allowed petitioner, as the cost of the lots it sold each year, an amount equal to 63.44655 per cent of the cost claimed by petitioner in its returns.

[fol. 14] The deficiency notice contains the following explanation for respondent's determination that petitioner realized additional income in the amount of $20,972.54 from the sale of lots in the year ended October 31, 1946:

> It is held that the cost of lots sold in the fiscal year ended October 31, 1946, reported in the return filed for that year as amounting to $57,375.00, is not in excess of the amount of $36,402.46, the reduction representing the allocable portion of the following items incorrectly included in the computation of the total cost of the lots in the subdivision (Sections 24(a)(2) and 43 of the Internal Revenue Code):

(a) Cost of water system	$33,781.70
(b) Deposits with utility companies	8,713.54
(c) Excessive provision, reserve for improvements	5,590.82
	$48,086.06

Similar explanations appear for the adjustments determined by respondent for the years ended October 31, 1947, and October 31, 1950.

The total amount of development costs includible in petitioner's basis in the subdivision lots is $53,702.09. This amount is the total of the development expenses incurred by petitioner which are not in issue, $44,988.55, and the total of the payments made by petitioner to the utility companies, $8,713.54. The estimated development costs claimed by petitioner, $93,074.61, were overstated in the total amount of $39,372.52. The basis in the subdivision lots claimed by petitioner, $131,550, also was overstated in the total amount of $39,372.52. Petitioner's basis in the subdivision lots did not exceed $92,177.48, or 70.07 per cent of the basis it claimed.

Petitioner's basis for gain in the lots it sold in the years ended October 31, 1946, 1947, and 1950, did not exceed 70.07 per cent of the basis claimed in its returns for each of these years. Petitioner's basis in the lots sold in these 3 years were $40,202.66, $13,015.50, and $5,255.25, respectively, computed as follows:
[fol. 15]

Year ended October 31	Basis per return	70.07 per cent of basis reported in return
1946	$57,375	$40,202.66
1947	18,575	13,015.50
1950	7,500	5,255.25

Statute of Limitations

Issue 3: In the taxable years ended October 31, 1946, and October 31, 1947, petitioner's gross income amounted to $39,422.37 and $23,654.91, respectively, computed as follows:

	Year ended October 31	
	1946	1947
Selling price of lots (per return)	$78,987.50	$28,075.00
Basis in lots	40,202.66	13,015.50
Profit from sale of lots	$38,784.84	$15,059.50
Other income (per return)	637.53	8,595.41
Total	$39,422.37	$23,654.91

In each of the years ended October 31, 1946, and October 31, 1947, petitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the amount of gross income stated in its returns. The following schedule sets forth, for the years ended October 31, 1946, and October 31, 1947, the amount of petitioner's gross income; the amount of gross income reported by petitioner; the amount of gross income omitted from petitioner's returns; and the percentage which the gross income omitted bears to the gross income reported:

	Year ended October 31	
	1946	1947
Gross income	$39,427.37	$23,654.91
Gross income reported	22,250.03	18,095.41
Gross income omitted	$17,172.34	$ 5,559.50
Gross income omitted as percentage of gross income reported	77.2%	30.7%

[fol. 16] Petitioner's income and declared value excess-profits tax return for the taxable year ended October 31, 1946, was filed on January 15, 1947. More than 3 years and less than 5 years later, on October 17, 1951, petitioner executed an agreement under the provisions of section 276(b) of the 1939 Code extending the period of limitations for the assessment and collection of deficiencies for the year ended October 31, 1946, to June 30, 1952. On May 14, 1952, petitioner executed a second agreement extending the period to June 30, 1953; and on April 25, 1953, petitioner executed a third agreement extending the period to June 30, 1954.

Petitioner's return for the taxable year ended October 31, 1947, was filed on December 22, 1947. More than 3 years and less than 5 years later, on May 14, 1952, petitioner executed an agreement under the provisions of section 276(b) of the Code extending the period of limitation to June 30, 1953. On April 25, 1953, petitioner executed a second agreement extending the period to June 30, 1954.

The respondent's statutory notice of deficiency for the years ended October 31, 1946, and October 31, 1947, was mailed on March 29, 1954.

[fol. 17] OPINION

HARRON, *Judge: Issue 1:* The first question to be decided is whether the payments made by petitioner to five of its stockholders in the amounts of $8,988.41, $3,468, and $3,468, in the taxable years ended October 31, 1948, 1949, and 1950, respectively, were payments of interest on indebtedness, which are deductible under section 23(b) of the 1939 Code, or whether the payments constituted nondeductible distributions in the nature of dividends. The determination of this issue depends on whether the $57,800 paid by the shareholders to petitioner in return for petitioner's notes constituted, in substance, a loan giving rise to a creditor-debtor relationship, or a contribution to capital, which gave the stockholders an additional proprietary interest.

The petitioner concedes that it is a "thin corporation." It argues, however, that the notes must be recognized as a valid indebtedness because the petitioner's capitalization reflected the business judgment of unrelated persons who dealt with each other at arm's length; because the notes were issued to the stockholders in face amounts which were disproportionate to their stock holdings; and because the transaction was carried out in the form proper to create an indebtedness, rather than a contribution to capital. The respondent takes the position that the $57,800 paid in by the shareholders must be considered as a contribution on their part to petitioner's capital, in view of the capital structure of the petitioner; the circumstances under which the notes were issued, and the lack of evidence indicating that the transaction was intended to create a debtor-creditor relationship.

The question to be decided is one of fact. *Sam Schnitzer,* 13 T.C. 43, 60, affd. 183 F.2d 70, certiorari denied 340 U.S. [fol. 18] 911. The issue is whether there was an intention to create a debtor-creditor relationship, on the one hand, or a capital contribution, on the other hand, "and such intention is a fact to be gleaned from the entire record." *Estate of Herbert B. Miller,* 24 T.C. 923. It is true, in this case, that the notes received by the 5 shareholders upon their payment of $57,800 to petitioner satisfy the formal requirements for a corporate indebtedness. However, our inquiry is not limited to the formalities, however meticu-

lously observed, in which the parties cast their transaction. *R. M. Gunn*, 25 T.C. —— (December 9, 1955); *Estate of Herbert B. Miller, supra; Gooding Amusement Co.*, 23 T.C. 408, 418; *Proctor Shop, Inc.*, 30 B.T.A. 721, affd. 82 F.2d 792. There are other factors present which establish that the $57,800 was paid over to petitioner by the stockholders to be placed immediately at the risk of petitioner's business as a capital contribution rather than as a true loan.

In the first place, the petitioner's formal capital, $1,000, was patently inadequate to carry on the business for which it was formed. The petitioner was organized to purchase, subdivide, and sell a substantial tract of land. For this purpose, petitioner's formal capital of $1,000 was wholly insignificant. To finance the project, the additional amount of $57,800 was turned over to petitioner by the stockholders, and in addition the petitioner obtained loans of at least $149,403 from banks. The bank loans were secured by liens on petitioner's real estate. The notes received by the stockholders were not secured. If petitioner's characterization of the transaction is accepted, it is apparent that petitioner's business was placed in operation with loans in the amount of $207,203, and formal capital in the amount of $1,000. This alleged arrangement, which amounts to an indebted- [fol. 19] ness to capital ratio of greater than 207-to-1, clearly establishes that petitioner was undercapitalized and strongly suggests that the shareholders recognized that the $57,800 would be risked in petitioner's business as a capital contribution to the same extent as the formal capital of $1,000. See *Hilbert L. Bair*, 16 T.C. 90, affd. 199 F.2d 589. In these circumstances, we think our language in *Isidor Dobkin*, 15 T.C. 31, 33, affd. 192 F.2d 392, is particularly appropriate:

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business. *Cohen* v. *Commissioner*, 148 F.2d 336; *Joseph B. Thomas*, 2 T.C. 193. The formal characterization as loans on the part of the controlling stockholders may be a relevant factor

but it should not be permitted to obscure the true substance of the transaction. *Sam Schnitzer*, 13 T.C. 43, 60.

The conclusion that the parties did not regard the payment of the $57,800 to petitioner as a loan is also supported by their conduct subsequent to the issuance of the notes in April 1946. For example, the notes were not paid on the due date, namely, 5 years after issue, i.e., in April 1951. In fact, the evidence indicates that only one of the notes, that issued to L. B. Shouse, has been retired, and that the other notes were still outstanding at the time of the hearing of this proceeding. The stockholders other than Shouse held their notes as late as 1953, 2 years after the due date, and the evidence does not indicate that any attempt to enforce payment was ever made at any time after the due date. The parties treated their shares of stock and the notes as part of a single package whenever a transfer was made. For example, when petitioner acquired Shouse's note, it also acquired his stock. Similarly, in the transaction in 1953, in which Sturgill and Central Rock Company acquired, in [fol. 20] equal shares, the outstanding stock of petitioner held by Meriwether, Blakely, Leet, and Nunn, the notes held by the latter four persons also were acquired.

On the basis of the foregoing, it is concluded that the petitioner has failed to establish that the notes issued to its shareholders in the face amount of $57,800 represented a valid indebtedness. It is held that the respondent properly disallowed the deductions claimed by petitioner for interest on indebtedness for the years ended October 31, 1948, 1949, and 1950, in the respective amounts of $8,988.41, $3,468, and $3,468.

In reaching our conclusion we have considered petitioner's contentions concerning the disproportionate holdings among the shareholders of stock and notes. Under the circumstances of this case, we attribute to this no greater weight than if petitioner had issued disproportionate amounts of common and preferred stock. Similarly, we consider of little weight petitioner's argument that the obligations represented by the notes were not subordinated to claims of other creditors. It is true that the notes, on their

face, were not subordinate obligations. Under the facts of this case, however, little significance can be attached to this factor. For one thing, there was a lien on petitioner's principal asset, its real estate, in favor of the banks. This lien secured loans made by the banks to petitioner in the original amount of at least $149,403. In the second place, it appears that petitioner's liabilities in each of the taxable years were in negligible amounts, compared to the $57,800 in question. For example, petitioner's liabilities at the end of the taxable years October 31, 1946, to October 31, 1950, ranged from a low of $986.04 on October 31, 1949, to a high of $5,325.74 on October 31, 1946, and averaged $2,470.29. On the entire record, it is concluded that the respondent must be sustained on this issue.

[fol. 21] *Cost of Subdivision Lots to Petitioner*

Issue 2: The narrow question to be decided under this issue is the proper amount which petitioner may add to its cost of Colony lots for the cost of development work in The Colony subdivision. It is well established that where subdivision lots are sold before development work is completed, the seller may include in his cost of the lots an allocation of his estimated future expenditures for improvements to the subdivision. *Country Club Estates, Inc.*, 22 T.C. 1283, 1293-1294; *Cambria Development Company*, 34 B.T.A. 1155.

The petitioner included in its cost of Colony subdivision lots a total of $93,074.12 for development expenses, and added a pro rata portion of this total to its cost of The Colony lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950. The respondent determined that the development expenses claimed by petitioner were excessive, and that the proper amount to be added to petitioner's cost of the lots did not exceed $44,988.55. The respondent accordingly reduced the cost or other basis which the petitioner claimed in the lots which were sold, and increased the profit reported by petitioner from the sale of these lots. The amount by which the respondent reduced the petitioner's cost or other basis in the lots in each of the years ended October 31, 1946, 1947, and 1950, equaled a pro rata part of $48,086.06, the total amount by which the respondent reduced the development costs claimed by petitioner. The

petitioner does not contest the percentage method used by respondent to redetermine the cost of the lots, in the event it is determined that petitioner overstated its development costs. The petitioner does claim, however, that its development costs were not overstated in the amount determined by the respondent.

[fol. 22] The amount of estimated development costs disallowed by respondent, $48,086.06, is the total of three items, namely, an expenditure of $33,781.70 to construct a water supply system; payments to utility companies in the amount of $8,713.54; and the sum of $5,590.82, which is the excess of the petitioner's estimated development costs of $93,074.61 over the total amount it claimed to have expended for development purposes as of September 30, 1950, namely, $87,483.79. The respondent, in effect, allowed as development costs the total amount petitioner claimed to have expended as of September 30, 1950, other than the cost of the water supply system and the amounts paid to utility companies.

The respondent's position under this issue is that the expenditures incurred to acquire the water supply system and to make payments to the utility companies are not properly chargeable to development costs which can be added to the cost of the subdivision lots. In the case of the portion of the estimated costs which petitioner had not expended as of September 30, 1950, or $5,590.82, the respondent contends that no part of the $5,590.82 will be required for future improvements, and that petitioner's original estimate of $93,074.61 for future developments was excessive in the amount of $5,590.82. The three adjustments will be discussed separately.

Petitioner introduced no evidence at the hearing of this proceeding to establish that further development work was required at The Colony after September 30, 1950, or that any expenditures were in fact made after that date for purposes of development or improvement. We accordingly sustain respondent's determination that the petitioner's estimate for future development costs, $93,074.61, was excessive in the amount of $5,590.82, which is the portion of petitioner's estimate which had not been expended as of September 30, 1950. *Butler-Fornari Realty Corporation*, 37 B.T.A. 933.

[fol. 23] The next item under this issue relates to the water supply system. The petitioner has abandoned its original contention that the entire cost of the water supply system is a development expense which can be allocated to its cost of the subdivision lots. It concedes now that the "distribution system" or piping which carried the water from the "pumping system" to the houses, is not a development expense. It now claims that only the cost of the pumping station or pumping system is a development cost which should be added to its cost of the lots. The petitioner contends that the lots were unsaleable without a water supply system, and that it was required to construct such a system because the cost of connecting the subdivision with the facilities of the Lexington Water Company was prohibitive. The petitioner contends further that when the facilities of the Lexington Water Company eventually extend to the subdivision, the pumping station will be of no further use and will have no value other than for salvage. The petitioner contends that under these facts, the cost of the pumping system must be added to its cost of the lots. The petitioner relies on *Country Club Estates, Inc., supra*. In that case, the taxpayer was in the business of selling subdivision lots. In order to induce people to purchase lots, the taxpayer conveyed a portion of its tract to a nonprofit organization for the purpose of having a country club constructed. It was held that the cost of the property transferred by the taxpayer should be regarded as part of its basis in the subdivision lots which it sold.

The difficulty with petitioner's contention is that, unlike the taxpayer in *Country Club Estates, Inc., supra*, the petitioner has not given up any property in order to sell its lots. For the funds it expended, the petitioner acquired a water supply system which it owned and operated during [fol. 24] the taxable years and thereafter. It is true that the system has not been operated at a profit, due, perhaps, to the small number of houses which have been constructed at The Colony. And it also may be true, as petitioner contends, that the pumping station may be abandoned at some time in the future, when the facilities of the Lexington Water Company reach the subdivision. These circumstances, however, do not alter the fact that the petitioner

retained full ownership and control of the water supply system during the taxable years, and that it did not part with the property for the benefit of the subdivision lots. Because of this retention of ownership, *Country Club Estates, Inc., supra,* is distinguishable. The retention of ownership also distinguishes this proceeding from cases in which the subdivider is permitted to add to his cost of lots the cost of land which has been dedicated or donated for use as streets. See, *Commissioner* v. *Laguna Land & Water Co.*, 118 F.2d 112, modifying, on other grounds, a Memorandum Opinion of the Board of Tax Appeals. We think the facts in this proceeding more closely resemble *Biscayne Bay Islands Co.*, 23 B.T.A. 731. In the latter case, the taxpayer subdivided for sale the waterfront portion of its property. The interior portion of its property was set aside, for a term of years only, and not irrevocably, for use as a public park. It was held that the taxpayer's cost of the waterfront lots did not include the cost of the interior park property because the taxpayer had not irrevocably parted with the interior property. We said (page 735):

> * * * This area was not permanently and irrevocably dedicated to the public, but may later be sold by petitioner. The possibility of gain has only been postponed. It is unlike the area used for public streets, which is permanently beyond the possibility of sale and gain, the cost of which must be absorbed in the salable lots. See *Oak Woods Cemetery Association,* 6 B.T.A. 1003.

[fol. 25] It is held that the cost of the water supply system may not be added to the cost of The Colony subdivision lots for the purposes of computing petitioner's gain on the sale of such lots.

There is an additional dispute between the parties which relates to the cost of the water supply system. The respondent determined that the total cost of the system which the petitioner had added to its cost of the lots was $33,781.70. The petitioner claims that the cost of the system was $33,277.61, or $504.09 less than the amount determined by respondent. The question is one of fact and the petitioner has the burden of proving the respondent's determination erroneous. The cost of the water supply system was not

separately stated in the books of account maintained by petitioner. Petitioner relies, in support of its contention, on an analysis of invoices made by the engineer who supervised the construction of the water supply system. However, the evidence indicates that the engineer did not have available all the invoices relating to the construction of the system. At one point the engineer testified that "practically all" the bills for materials and services came into his hands; elsewhere, he stated that the bills of which he had knowledge accounted for about 80 per cent of the cost of the project. In either event, the petitioner has not established that the engineer upon whose testimony it relies had knowledge of the total cost of the system. It is concluded that the petitioner has failed to establish that the cost of the water supply system was less than the amount determined by the respondent. It is held that the cost of the water supply system was $33,781.70, and that this amount is not includible in the cost of The Colony lots sold by petitioner.

The final question relating to the petitioner's cost of The Colony lots concerns the payments made by petitioner to the Gas Company and to Utilities Company. The petitioner [fol. 26] made payments to the companies in the total amount of $8,713.54, and included this amount in the cost of its Colony lots. The respondent takes the position that the petitioner is not entitled to add any part of the payments to the cost of the lots it sold during the taxable years, because there existed a possibility that all or a part of the payments might be refunded to petitioner at some time after the taxable years.

The evidence establishes that the companies required the payments to be made before they would extend their services to Colony. The payments were made to the companies in accordance with written agreements, the pertinent provisions of which are stated in the findings. Pursuant to the contract with the Gas Company, the petitioner paid $6,535 to the Gas Company in January 1948. The contract provided that the petitioner would receive a refund of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from the date of the contract, i.e., after October 16, 1956. In the case of the second compa[redacted], the Utilities Company,

the petitioner made payments in the total amount of $2,178.54 in 1948 and 1949. The contracts with the Utilities Company provided that a refund of approximately $160 would be paid to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions provided in the contract. The period during which petitioner was entitled to receive refunds from the Utilities Company did not expire during the taxable years.

It is true, therefore, as respondent contends, that there was no way to ascertain, during the taxable years, the total amount of refunds which petitioner might receive under its [fol. 27] contracts with the two companies. We do not think, however, that this circumstance militates against the petitioner. The determinative factor is that the petitioner made unconditional payments to the two companies in order to obtain utility service for The Colony, and thereby to attract customers for The Colony lots. The payments were thus closely related to the sale of the lots, and petitioner's income from the sale of lots will be more clearly reflected if a pro rata portion of the payments in question are included in its basis for gain or loss in each lot which was sold. On the other hand, the receipt of refund payments from the utility companies is less closely related to the improvement of the lots for sale. The payment of a refund would be made only if a new customer was connected to the utility companies' service extensions, rather than at the time a lot was sold. Thus, if lots were sold to purchasers who, for some reason, did not proceed to construct residences, the petitioner would not receive refunds; or, if a purchaser acquired two or more lots, on which only one residence was constructed, the petitioner would receive only one refund, rather than a number of refund payments equal to the number of lots sold to the purchaser. Under these circumstances, it is concluded that the payments to the utility companies were directly related to the improvement of The Colony lots for sale, and that the petitioner correctly included these payments in computing its basis for gain or loss in the lots which it sold. The question of the taxability of the refunds which petitioner may receive from the utility companies is not before

us. It is noted, however, that the petitioner concedes, on brief, that such refunds would, if made, constitute taxable income. See, *Chevy Chase Land Co.*, 34 B.T.A. 150.

Issue 3: The final question to be decided is whether the deficiencies determined for the taxable years ending October 31, 1946, and October 31, 1947, are barred by the statute of limitations. The deficiency notices for these 2 years [fol. 28] were mailed within the extended period provided in waivers which the petitioner originally executed more than 3 years and less than 5 years after the returns were filed. The question is whether the 5-year statute of limitations contained in section 275(c) of the 1939 Code[1] is applicable in this proceeding. The petitioner omitted from gross income in each year an amount properly includible therein which was in excess of 25 per cent of the gross income reported. The petitioner contends, however, that section 275 (c) is inapplicable because the omission resulted from an overstatement of cost of goods sold, rather than from an omission of gross receipts. The petitioner relies on *Uptegrove Lumber Co.* v. *Commissioner*, 204 F.2d 570, reversing a Memorandum Opinion of this Court, and on *Deakman-Wells Co., Inc.* v. *Commissioner*, 213 F.2d 894, reversing 20 T.C. 610. Our holding in *Estate of J. W. Gibbs, Sr.*, 21 T.C. 443, however, requires that this issue be decided in favor of the respondent. We have recently reviewed the decision in the *Gibbs* case in the light of the decisions in the *Uptegrove Lumber Co.* and *Deakman-Wells Co., Inc.* cases, and have decided to adhere to the rule in the *Gibbs* case. *John E. Goodenow*, 25 T.C. —— (October 6, 1955). On the basis

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[1] SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

* * * * * * *

(c) Omission From Gross Income.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

of the *Gibbs* and *Goodenow* cases, it is held that the 5-year statute of limitations in section 275(c) is applicable, and that the deficiencies determined for the years ending October 31, 1946, and October 31, 1947, are not barred by the statute of limitations.

Decision will be entered under Rule 50.

[fol. 30]

Computation proved

Fiscal Year

Form 120

Treasury Department
Internal Revenue Service

UNITED STATES
CORPORATION INCOME AND DECLARED VALUE EXCESS-PROFITS TAX RETURN 1945

THE TAX COURT OF THE U.S. DIV. 13 DECEMBER ... ADMITTED ... OCT 26 1955 PETITIONER'S EXHIBIT RESP...

For Calendar Year 1945

or fiscal year beginning Nov. 14, 1945, and ending Oct. 31, 1946

PRINT PLAINLY CORPORATION'S NAME AND ADDRESS

The Colony (Name)

c/o Charlie Sturgill Motor Co. (Street and number)

Lexington (City or town, postal zone number) Kentucky (State)

NOT INVESTIGATED

Kind of business: Farm - Subdivision

Business group serial number (from Instruction N) ..... Number of places of business .....

File Code 1947 10
Serial No. 111
District Kentucky
(Number) (street)
FAY...
JAN 1947
L...
C... Church M. O.
First Payment
$ 1617 11

RECD WITH LETTER DATED JA. 15 1947 COLL. INT. DIST. OF KY.

Item and Instruction No.			
	GROSS INCOME		
1.	Gross sales (where inventories are an income-determining factor) $; Less: Returns and allowances $		
2.	Less: Cost of goods sold. (From Schedule A)		
3.	Gross profit from sales		
4.	Gross receipts (where inventories are not an income-determining factor) $		
5.	Less: Cost of operations. (From Schedule B)		
6.	Gross profit where inventories are not an income-determining factor		
7.	Interest on loans, notes, mortgages, bonds, bank deposits, etc.		
8.	Interest on corporation bonds, etc. $ Less Amortizable Bond Premium $		
9.	(a) Interest on United States savings bonds and Treasury bonds owned in excess of the principal amount of $5,000 issued prior to March 1, 1941. (From Schedule M, line 18 (a) (2) (iii))		
	(b) Interest on Treasury notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. (Submit schedule)		
10.	Rents		
11.	Royalties		
12.	(a) Excess of net short-term capital gain over net long-term capital loss. (From Schedule C)		
	(b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule D)		
13.	Dividends. (From Schedule E)		
14.	Other income. (State nature)		
15.	Total income in items 3, and 6 to 14, inclusive		$ 22,250 03
	DEDUCTIONS		
16.	Compensation of officers. (From Schedule F)	$	
17.	Salaries and wages (not deducted elsewhere)		
18.	Rent		
19.	Repairs		
20.	Bad debts (From Schedule G)		
21.	Interest		
22.	Taxes. (From Schedule H) (Deduct declared value excess-profits tax as item 35)		
23.	Contributions or gifts paid. (From Schedule I)		
24.	Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule)		
25.	Depreciation. (From Schedule J)		
26.	Depletion of mines, oil and gas wells, timber, etc. (Submit schedule)		
27.	Net operating loss deduction. (Submit statement)		

Schedule

91

27

[fol. 31]

computation proved

Form 1121
Treasury Department
Internal Revenue Service

Fiscal Year

UNITED STATES
CORPORATION EXCESS PROFITS TAX RETURN
For Calendar Year 1945

Page 1

1945

or fiscal year beginning Nov. 14, 1945, and ending Oct. 31, 1946

PRINT PLAINLY CORPORATION'S NAME AND ADDRESS

The Colony
(Name)
c/o Charlie Sturgill Motor Co.,
(Street and number)
Lexington, Kentucky
(City or town, postal zone number) (State)

Business group serial number entered on page 1, Form 1120

File Code
Serial No.
District

EXCESS PROFITS TAX COMPUTATION

	Column 1 Income Credit Method	Column 2 Invested Capital Credit Method
1. Excess profits net income (line 18, Schedule A)		$ 18,313 00
2. Specific exemption		$ 10,000 00
3. Excess profits credit—based on income (line 40, Schedule B)		x x x x x x x x x x
4. Excess profits credit—based on invested capital (line 40, Schedule C)	x x x x x x x x x x	$ 3,228 29
5. Unused excess profits credit adjustment (attach schedule)		
6. Total of items 2 to 5		$ 13,228 29
7. Difference between item 1 and item 6		$ 5,084 71
8. Adjusted excess profits net income (item 7, column 1, or item 7, column 2, whichever is applicable)		$ 5,084 71
9. 95 percent of item 8		$ 4,830 47
10. Net income (item 30, page 1, Form 1120)		$
11. Less: (a) Dividends received credit (85 percent of total of column 2, Schedule F, Form 1120, but not in excess of 85 percent of item 10 above (excluding from the computation dividends received on certain preferred stock of a public utility))	$	
(b) Credit for dividends paid on certain preferred stocks if taxpayer is a public utility (20 percent of line 20, page 2, Form 1120)		
12. Surtax net income (computed without regard to the credit provided in section 26 (e) (sum of lines 18 and 21, page 2, Form 1120) and without regard to 80 percent of the credit provided in section 26 (h))		$
13. 80 percent of item 12		
14. Income tax under Chapter 1 (other than section 102) for the taxable year (item 42, page 1, Form 1120)		
15. Excess of item 13 over item 14		$
16. Item 9, or item 15, whichever is lesser		$
17. Amount deferred by reason of the application of section 710 (a) (5) (relating to abnormality under section 722) (attach schedule)		$
18. Excess profits tax:		
(a) Item 16 minus item 17	$	
(b) If schedule is filed under question (g), page 2, amount of tax as computed in such schedule		
(c) Item 18 (a) or item 18 (b), whichever is applicable		$
19. Less: Credit for income taxes paid to a foreign country or United States possession allowed to a domestic corporation (portion not used in computing item 43, page 1, Form 1120)		
20. Item 18 (c) minus item 19		$
21. Less: Credit against excess profits tax (10% of item 18 (c))		$ 483 06
22. Item 20 minus item 21		$ 4,347 41
23. Amount, if any, due to application of section 734 (adjustment in case of position inconsistent with prior income tax liability) (attach schedule)		
24. Excess profits tax due (item 22 plus item 23, or item 22 minus item 23, whichever is applicable)		$ 573 38

Prorated for Fiscal Year 15/350 of $ 347.43

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder.

[fol. 32]

Page 2

QUESTIONS

(a) Date of incorporation Nov. 14, 1945 (b) State or country Ky

(c) Collector's office in which your income tax return for the taxable year was filed Ky

(d) Is this a consolidated return? No If so, procure from the collector Form 851, Affiliations Schedule, which shall be filled in, sworn to, and filed as a part of the consolidated income tax return.

(e) In computing the excess profits credit under the invested capital method, do you elect to include in excess profits net income interest received on, reduced by the amount of amortizable bond premium under section 125 attributable to, all Government obligations described in section 22(b)(4) of the Internal Revenue Code? (Answer "yes" or "no") No

(f) Are you a transferor or transferee upon an exchange as defined by section 760 or 761 of the Internal Revenue Code? (Answer "yes" or "no") No

(g) Does this return involve an adjustment of the excess profits tax liability due to the application of the sections specified in (1) below? (Answer "yes" or "no") No If answer is "yes":

(1) Check the appropriate sections and submit schedules showing computation: 710(a)(4) ☐; 721 ☐; 726 ☐; 731 ☐; 735(b) ☐; 735(c) ☐; 736(a) ☐; 736(b) ☐. (See General Instructions E, F, G, H, and I.) (Enter amount of excess profits tax as Item 18 (b), page 1.

(2) From the schedules submitted under (1) above, enter any tax adjustment which results from the application of each of the following sections: 721, $; 726, $; 731, $

(3) From the schedules submitted under (1) above, enter any income adjustment which results from the application of each of the following sections: 721, $; 731, $; 735(b), $, 735(c), $

(h) State amount of total assets as of the end of the taxable year. (From Form 1120, page 4, line 8, last column.) $

(i) Has a constructive average base period net income under section 722 been used in computing the excess profits credit used on this return? If the answer is "yes," was such constructive average base period net income finally determined? Or, if not finally determined, is it used pursuant to permission granted by the Commissioner? If the answer to the first question is "yes," the following questions should be answered and the required information furnished:

(1) Is the amount of the constructive average base period net income so used the same as that which was finally determined or permitted? If the answer is "no," attach statement setting forth reasons for the variance and the amount thereof.

(2) If the constructive average base period net income resulted from the application of section 722 (b) (4) or (5) or section 722 (c), are the facts and circumstances different in the taxable year from the facts and circumstances with respect to which the claim for relief was first allowed? If so, attach statement containing a brief description of the difference and an account of its effect upon the business of the taxpayer for the taxable year.

(3) State the amount of the excess profits credit for the taxable year computed without regard to section 722. $

(j) Is any unused excess profits credit adjustment computed with the use of a constructive average base period net income? If the answer is "yes," attach schedule showing computation.

Schedule A. EXCESS PROFITS NET INCOME COMPUTATION

Line No.		Column 1 Income Credit Method		Column 2 Invested Capital Credit Method	
1.	Normal-tax net income (computed without allowance of credit for income subject to excess profits tax and without allowance of dividends received credit) (item 38, page 1, Form 1120)	$		$ 18,273	62
2.	Net short-term capital gain (do not enter net short-term capital loss)				
3.	Adjustment to net operating loss deduction				
4.	Decrease in deductions limited by income				
5.	80 percent of interest on borrowed capital	x x x x x x x	x x	39	38
6.	Interest on Government obligations (see question (e) above, for election)	x x x x x x x	x x		
7.	Total of lines 1 to 6	$		$ 18,313	00
8.	Net gain from sale or exchange of capital assets (item 12 (a) plus item 33, page 4, Form 1120)	$		$	
9.	Income from retirement or discharge of bonds, etc.				
10.	Refunds and interest on Agricultural Adjustment Act taxes				
11.	Recoveries of bad debts				
12.	Increase in deductions limited by income				
13.	(a) Dividends received credit adjustment (item 13, page 1, Form 1120, excluding dividends received from foreign corporations)			x x x x x x x	x x
	(b) Dividends received credit adjustment (item 13, page 1, Form 1120, excluding dividends received from foreign personal holding companies and dividends received on stock held primarily for sale to customers by a dealer in securities)	x x x x x x x	x x		
14.	Nontaxable income of certain industries with depletable resources				
15.	Total of lines 8 to 14	$		$	
16.	Excess profits tax net income computed without regard to deductions applicable to life insurance companies (line 7 minus line 15)	$		$	
17.	Deductions applicable to life insurance companies				
18.	Excess profits net income computed under income credit method or invested capital credit method (line 16, or line 16 minus line 17 in case of a life insurance company)	$		$ 18,313	00

16—61130-4

Page 4

Schedule C.—EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL

Line No.			
	Equity Invested Capital at the Beginning of the Taxable Year (See instructions for Schedule C, lines 1 to 12, inclusive)		
1.	Money paid in for stock, or as paid-in surplus, or as a contribution to capital		$ -0-
2.	Property paid in for stock, or as paid-in surplus, or as a contribution to capital		-0-
3.	Distributions of earnings and profits in stock of the corporation		-0-
4.	(a) Accumulated earnings and profits	$	
	(b) Adjustment for transferor's deficit under section 718 (c) (5)	$	
	(c) Increase or decrease under section 761 (d) (1) on account of intercorporate liquidation	$	
	(d) Accumulated earnings and profits (item 4 (a)) as adjusted by item 4 (b) and (c)		-0-
5.	25 percent of new capital paid in during a taxable year beginning after December 31, 1940		-0-
6.	Increase on account of intercorporate liquidation under section 761 (d) (2)		-0-
7.	Deficit in earnings and profits of another corporation under section 718 (a) (7)		-0-
8.	Total of lines 1 to 7		$ -0-
9.	Less: Distributions made prior to the taxable year not out of accumulated earnings and profits	$	
10.	Earnings and profits of another corporation required to be deducted by section 718 (b) (3)		
11.	Decrease on account of intercorporate liquidation under section 761 (d) (2)		
12.	Deficit in earnings and profits included in invested capital of another corporation (section 718 (b) (5))		
13.	Total of lines 9 to 12		-0-
14.	Equity invested capital at beginning of taxable year (line 8 minus line 13)		$ -0-
	Average Addition to Equity Invested Capital During the Taxable Year (See instructions for Schedule C, lines 1 to 12, inclusive)		
15.	Money paid in for stock, or as paid-in surplus, or as a contribution to capital	$	
16.	Property paid in for stock, or as paid-in surplus, or as a contribution to capital		
17.	Distributions of earnings and profits (other than earnings and profits of the taxable year) in stock of the corporation (see line 24, below)		
18.	25 percent of new capital		
19.	Increase on account of intercorporate liquidation under section 761 (d) (2)		
20.	Deficit in earnings and profits of another corporation under section 718 (a) (7)		
21.	Total additions in lines 15 to 20		-0-
22.	Total of lines 14 and 21		$
	Average Reduction in Equity Invested Capital During the Taxable Year (See instructions for Schedule C, lines 1 to 12, inclusive)		
23.	Distributions not out of earnings and profits of the taxable year	$	
24.	Stock distributions from accumulated earnings and profits at beginning of year (see line 17, above)		
25.	Decrease on account of intercorporate liquidation under section 761 (d) (2)		
26.	Deficit in earnings and profits included in invested capital of another corporation (section 718 (b) (5))		
27.	Total reductions in lines 23 to 26		-0-
	(See instructions for Schedule C, lines 28 to 40, inclusive)		
28.	Average equity invested capital (line 22 minus line 27)		$
29.	Average borrowed capital (attach schedule)	$ 80,707 29	
30.	Average borrowed invested capital (50 percent of line 29)		40,353 65
31.	Average invested capital (line 28 plus line 30)		$ 40,353 65
32.	Total inadmissible assets	$	
33.	Total admissible and inadmissible assets	$	
34.	Percentage which line 32 is of line 33	%	
35.	Reduction on account of inadmissible assets (..... percent of line 31)		-0-
36.	Invested capital (line 31 minus line 35)		$ 40,353 65
37.	Portion of line 36 (not over $5,000,000); and credit at 8 percent	$	8% $ 3,228 29
38.	Portion of line 36 (over $5,000,000, but not over $10,000,000); and credit at 6 percent		6%
39.	Portion of line 36 (over $10,000,000); and credit at 5 percent		5%
40.	Excess profits credit—based on invested capital (total of lines 37 to 39)		$ 3,228 29

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THE COLONY, INCORPORATED
Lexington, Kentucky
Schedules Submitted with Income Tax Return
Taxable Year Ended October 31, 1946

Schedule B - Balance Sheet as at October 31, 1946

ASSETS

Cash in Bank	863.01	
Accounts Receivable	71,631.25	
First National Bank and Trust Co. as		
Escrow Agent, Account No. 1	44,535.00	
Escrow Agent, Account No. 2	8,356.25	
Bosworth Farm - Land	72,282.88	
The Colony Subdivision	74,175.00	
Farm Buildings and Fencing	29,000.80	
Farm Equipment	670.00	
Live Stock	2,478.35	
Total Assets		303,992.54

LIABILITIES

Notes Payable - Bank Loans	149,403.00	
Notes Payable - Stockholders	57,800.00	
Accounts Payable	165.65	
Reserve for Improvements	76,074.12	
Reserve for Depreciation	706.00	
Accrued Federal Income Tax	4,589.94	
Accrued Kentucky Income Tax	570.15	
Capital Stock, 400 Shares (No Par)	1,000.00	
Surplus - Earned	13,683.68	
Total Liabilities		303,992.54

(b) Net gain (or loss) from sale or exchange of property other than capital assets (Schedule D)

13. Dividends. (From Schedule E)			
14. Other income. (State nature)			
15. Total income in items 3, and 6 to 14, inclusive	Schedule		$ 22,250 03

DEDUCTIONS

16. Compensation of officers. (From Schedule F)	$		
17. Salaries and wages (not deducted elsewhere)			
18. Rent			
19. Repairs			
20. Bad debts (From Schedule G)			
21. Interest			
22. Taxes. (From Schedule H) (Deduct declared value excess-profits tax as item 35)			
23. Contributions or gifts paid. (From Schedule I)			
24. Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule)			
25. Depreciation. (From Schedule J)			
26. Depletion of mines, oil and gas wells, timber, etc. (Submit schedule)			
27. Net operating loss deduction. (Submit statement)			
28. Amortization of emergency facilities. (Submit schedule)			
29. (a) Advertising			
(b) Amounts contributed under a pension, annuity, stock bonus, or profit-sharing plan, etc.			
(c) Other deductions authorized by law. (From Schedule K)			
30. Total deductions in items 16 to 29, inclusive	Schedule		$ 3,976 41
31. Net income for declared value excess-profits tax computation (item 15 minus item 30)			$ 18,273 62
32. Add: Interest on obligations of certain instrumentalities of the United States issued prior to March 1, 1941. (From Schedule M, line 15 (a) (2) (ii)) $ ... Less amortizable bond premiums, $			-0-
33. Excess of net long-term capital gain over net short-term capital loss. (From Schedule C)			-0-
34. Total of lines 31, 32, and 33			$
35. Less: Declared value excess-profits tax			-0-
36. Net income			$
37. Less: Interest on certain obligations of the United States and its instrumentalities issued prior to March 1, 1941. (Enter total of lines 9 (a) and 32)			-0-
38. Adjusted net income			$ 18,273 62
39. Less: Adjusted excess profits net income from Form 1121. (See instruction on page 9)	$		
40. Dividends received credit (85 percent of column 2, Schedule E, but not in excess of 85 percent of item 38 minus item 39, above)			
41. Normal-tax net income			$

TOTAL INCOME AND DECLARED VALUE EXCESS-PROFITS TAXES

42. Total income tax (line 28 or 30, page 2, whichever is applicable)	$	
43. Less: Credit for income taxes paid to a foreign country or United States possession allowed a domestic corporation		
44. Balance of income tax		
45. Total declared value excess-profits tax (line 8, page 2)		
46. Total income and declared value excess-profits taxes due	Fiscal year, Schedule X	$ 4,011 [illegible]

AFFIDAVIT. (See Instruction E)

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return, made in good faith for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder.

Subscribed and sworn to before me this 4th day of January, 1947.

My Commission Expires December 27, 1948

NOTARIAL SEAL

Mary Louise Fagan
(Signature of officer administering oath) (Title)
Notary Public, Fayette County, Kentucky

CORPORATE SEAL

[illegible]
(Signature of Treasurer or Chief Accounting Officer)
(Print name)

AFFIDAVIT. (See Instruction E)

I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this 4 day of January, 1947

My Commission Expires December 27, 1948

NOTARIAL SEAL

Mary Louise Fagan
(Signature of officer administering oath) Notary Public, Fayette County, Kentucky

[illegible]
(Signature of person preparing this return)

[illegible] FORTUNE
(Name and address of individual preparing the return)
Corporation
(Name of firm, if any)
[illegible]
(Street and number, if any)

The Colony

(Name)

c/o Charlie Sturgill Motor Co.,

(Street and number)

Lexington, Kentucky

(City or town, postal zone number) (State)

Business group serial number entered on page 1, Form 1120

FA

Cash Check M. O.

$ 85

EXCESS PROFITS TAX COMPUTATION

	Column 1 Income Credit Method	Column 2 Invested Capital Credit Method
1. Excess profits net income (line 18, Schedule A)		$ 18,313 00
2. Specific exemption		$ 10,000 00
3. Excess profits credit—based on income (line 40, Schedule B)		xxxxxxx xx
4. Excess profits credit—based on invested capital (line 40, Schedule C)	xxxxxxx xx	8,228 29
5. Unused excess profits credit adjustment (attach schedule)		
6. Total of items 2 to 5		$ 18,228 29
7. Difference between item 1 and item 6	$	$ 5,084 71
8. Adjusted excess profits net income (item 7, column 1, or item 7, column 2, whichever is applicable)		$ 5,084 71
9. 95 percent of item 8		$ 4,830 47
10. Net income (item 36, page 1, Form 1120)		$
11. Less: (a) Dividends received credit (85 percent of total of column 2, Schedule E, Form 1120, but not in excess of 85 percent of item 10 above (excluding from the computation dividends received on certain preferred stock of a public utility))	$	
(b) Credit for dividends paid on certain preferred stocks if taxpayer is a public utility (20 percent of line 20, page 2, Form 1120)		
12. Surtax net income (computed without regard to the credit provided in section 26 (e) (sum of lines 18 and 21, page 2, Form 1120) and without regard to 80 percent of the credit provided in section 26 (h))		$
13. 80 percent of item 12		
14. Income tax under Chapter 1 (other than section 102) for the taxable year (item 42, page 1, Form 1120)		
15. Excess of item 13 over item 14		$
16. Item 9, or item 15, whichever is lesser		$
17. Amount deferred by reason of the application of section 710 (a) (5) (relating to abnormality under section 722) (attach schedule)		$
18. Excess profits tax:		
(a) Item 16 minus item 17	$	
(b) If schedule is filed under question (g), page 2, amount of tax as computed in such schedule		
(c) Item 18 (a) or item 18 (b), whichever is applicable		$
19. Less: Credit for income taxes paid to a foreign country or United States possession allowed to a domestic corporation (portion not used in computing item 43, page 1, Form 1120)		
20. Item 18 (c) minus item 19		$
21. Less: Credit against excess profits tax (10% of item 18 (c))		$ 482 96
22. Item 20 minus item 21		$ 4,347 43
23. Amount, if any, due to application of section 734 (adjustment in case of position inconsistent with prior income tax liability) (attach schedule)		
24. Excess profits tax due (item 22 plus item 23, or item 22 minus item 23, whichever is applicable)		$ 434 74

Prorated for Fiscal Year 45/350 of 4,347.43

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return; made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder.

Subscribed and sworn to before me this 14 day of January, 194 7

My Commission Expires December 27, 1948

NOTARIAL SEAL

Mary Louise Hagan

(Title)

Notary Public, Fayette County, Kentucky

Hyde Motor Co.

(Name of corporation or other principal officer) (State title)

CORPORATE SEAL

Hyde Sturgill

(President, Assistant Treasurer, or Chief Accounting Officer) (State title)

I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the excess profits tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this 4 day of January, 194 7

My Commission Expires December 27, 1948

NOTARIAL SEAL

Mary Louise Hagan

(Title)

W. H. Turner

(Signature of person preparing this return)

W. H. TURNER

(Name of person preparing this return)

C.P.A.

(Address)

THE COLONY, INCORPORATED
Lexington, Kentucky
Schedules Submitted with Income Tax Return
Taxable Year Ended October 31, 1946

Schedule A - Income

REVENUE

Sales of 39 lots "The Colony Subdivision"		78,987.50	
Less Cost of Lots Sold		57,375.00	
Profit on Lot Sales		21,612.50	
Sales of Farm Products		637.53	
Total Gross Revenue			22,250.03

DEDUCTIONS

Advertising			532.02	
Directors Expense			47.07	
Fertilizer			221.50	
Hauling			7.72	
Insurance			631.20	
Interest			78.75	
Salaries and Wages			853.81	
Seed and Feed			39.67	
Supplies - Farm			60.04	
Supplies - Office			130.10	
Taxes and Licenses			65.25	
Telephone and Telegraph			.83	
Gas and Oil			32.30	
Depreciation, 6 Months:				
5 Barns	23,000.00 @ 5%	575.00		
1 House	3,500.00 @ 5%	87.50		
2 Mules	100.00 @ 20%	10.00		
Farm Equipment	670.00 @ 10%	33.50	706.00	
Sub-total			3,406.26	
Accrued Kentucky Income Tax			570.15	
Total Deductions				3,976.41
Taxable Income				18,273.62
Deduct:				
Accrued Federal Income Tax				4,589.94
Surplus Addition for Year				13,683.68

THE COLONY, INCORPORATED
Lexington, Kentucky
Schedules Submitted with Income Tax Return
Taxable Year Ended October 31, 1946

Schedule I, Computation of Normal and Surtax for Fiscal Year

Tax Computed at 1945 Rates:						
Net Income, Line 38, Form 1120					18,273.62	
Less Excess Profits Income, Line 8, Form 1121					5,084.71	
Subject to Normal and Surtax					13,188.91	
Normal tax on	5,000.00	@	15%	750.00		
Do	8,188.91	@	17%	1,392.11	2,142.11	
Surtax on	13,188.91	@	10%		1,318.89	
Total at 1945 Rates					3,461.00	
Pro-rated 46/350ths						454.87
Tax Computed at 1946 Rates:						
Net Income, Line 38, Form 1120					18,273.62	
Normal tax on	5,000.00	@	15%	750.00		
Do	13,273.62	@	17%	2,256.52	3,006.52	
Surtax on	18,273.62	@	6%		1,096.41	
Total at 1946 Rates					4,102.93	
Pro-rated 304/350ths						3,563.69
Total Normal Tax and Surtax						4,018.56

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Schedule E.—INCOME FROM DIVIDENDS

Page

1. Name and Address of Payer Corporation	2. Domestic Corporations Taxable Under Chapter 1, Internal Revenue Code	3. Foreign Corporations	4. Other Corporations
	$	$	$
Totals	$	$	$
Total of columns 2, 3, and 4. (Enter as item 13, page 1)			$

*Except dividends received from corporations organized under the China Trade Act, 1922, and corporations entitled to the benefits of section 251 of the Internal Revenue Code, which dividends should be entered in column 4.

Dividends on share accounts in Federal savings and loan associations in case of share accounts issued prior to March 28, 1942, should not be listed, but the amount should be included in items 28 and 37, page 1; dividends on share accounts issued on or after March 28, 1942, should be reported in column 4.

Schedule F.—COMPENSATION OF OFFICERS

1. Name and Address of Officer	2. Official Title	3. Time Devoted to Business	Percentage of Corporation's Stock Owned		6. Amount of Compensation
			4. Common	5. Preferred	
					$
Total compensation of officers. (Enter as item 16, page 1)					$

NOTE.—Schedule F-1 (IN DUPLICATE) also must be filed with this return if compensation in excess of $75,000 was paid to any officer or employee.

Schedule G.—BAD DEBTS. (See Instruction 20) (See notes 1 and 2)

1. Taxable Year	2. Net Income Reported	3. Sales on Account	4. Bad Debts of Corporation If No Reserve Is Carried on Books (See note 2)	If Corporation Carries a Reserve—	
				5. Gross Amount Added to Reserve	6. Amount Charged Against Reserve
1941	$	$	$	$	$
1942					
1943					
1944					
1945					

1. Check whether deduction claimed represents debts which have become worthless ☐, or is an addition to a reserve ☐.
2. Not including securities which are capital assets and which became worthless within the taxable year. Such securities which became worthless within the year should be reported in Schedule C.

Schedule H.—TAXES. (See Instruction 22)

Nature	Amount
	$
Total. (Enter as item 22, page 1)	$

Schedule I.—CONTRIBUTIONS OR GIFTS PAID. (See Instruction 23)

Name and Address of Organization	Amount
	$
Total. (Enter as item 23, page 1, subject to 5 percent limitation.) (See Instruction 23)	$

Schedule J.—DEPRECIATION. (See Instruction 25)

1. Kind of Property (If buildings, state material of which constructed)	2. Date Acquired	3. Cost or Other Basis (Do not include land or other nondepreciable property)	4. Assets Fully Depreciated in Use at End of Year	5. Depreciation Allowed (or allowable) in Prior Years	6. Remaining Cost or Other Basis To Be Recovered	7. Estimated Life Used in Accumulating Depreciation	8. Estimated Remaining Life From Beginning of Year	9. Depreciation Allowable This Year
		$	$	$	$			$
Total. (Enter as item 25, page 1)								$

Schedule K.—OTHER DEDUCTIONS. (See Instruction 29)

QUESTIONS

1. Date incorporated Nov. 14-1945 2. State or country Ky.
3. If incorporated in 1945, indicate whether (a) completely new business ☐, or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate) ..... If successor to previously existing business, give name and address of the previous business organization .....
4. Collector's office where the corporation's return for the preceding year was filed .....
5. Enter amount of income (or deficit) from Item 34, page 1, Form 1120 for 1944 .....
6. The corporation's books are in care of Charles Bingell
Located at Lexington, Ky.
7. Enter the approximate number of stockholders at the close of the taxable year 1
8. Did the corporation during the taxable year have any Government contracts or subcontracts? (Answer "yes" or "no") No If answer is "yes," state the approximate aggregate gross dollar amount billed during the taxable year under all such contracts and/or subcontracts. (See Instruction G-(3).) $.....
9. Is the corporation a personal holding company within the meaning of section 501 of the Internal Revenue Code? No (If so, an additional return on Form 1120 H must be filed.)
10. Is this a consolidated return? No (If so, procure from the collector of internal revenue for your district Form 851, Affiliations Schedule, which shall be filled in, sworn to, and filed as a part of this return.)
11. If this is not a consolidated return: (a) did the corporation own at any time during the taxable year 50 percent or more of the voting stock of another corporation either domestic or foreign? No; or (b) did any corporation, individual, partnership, trust, or association own at any time during the taxable year 50 percent or more of the corporation's voting stock? ..... (If either answer is "yes," attach separate schedule showing: (1) Name and address; (2) percentage of stock owned; (3) date stock was acquired; and (4) the collector's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.)
12. Is this return made on the basis of cash receipts and disbursements? No If not, describe fully in separate statement Accruals
13. Has the corporation in this return taken a deduction for any amount of wages or salaries representing an increase or decrease in rate? (Answer "yes" or "no") No If so, attach statement as required by Instructions 16 and 17.
14. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower ..... If other basis is used, explain fully in separate statement, giving date inventory was last reconciled with stock.
15. Did the corporation make a return of information on Forms 1096 and 1099 or Form W-2a for the calendar year 1945 (see Instruction G-(1))? No
16. Has any transaction described in Instruction G-(6) occurred on or after October 8, 1940? (Answer "yes" or "no") No
17. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? No (If so, submit statement as required by Instruction K-(2).)

Schedule L.—BALANCE SHEETS. (See Instruction I.)

ASSETS	Beginning of Taxable Year: Amount	Beginning of Taxable Year: Total	End of Taxable Year: Amount	End of Taxable Year: Total
1. Cash		$		$
2. Notes and accounts receivable	$		$	
Less: Reserve for bad debts				
3. Inventories (itemize in separate schedule)				
4. Investments in governmental obligations:				
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	$		$	
(b) Obligations of the United States				
(1) Obligations issued on or before September 1, 1917; all postal savings bonds; Treasury notes issued prior to December 1, 1940, and Treasury bills issued prior to March 1, 1941				
(2) United States savings bonds and Treasury bonds issued prior to March 1, 1941				
(3) Treasury notes issued on or after December 1, 1940, and all other obligations of the United States issued on or after March 1, 1941				
(c) Obligations of instrumentalities of the United States				
(1) Obligations of Federal land banks, joint stock land banks, and Federal intermediate credit banks issued prior to March 1, 1941				
(2) Obligations issued by other instrumentalities of the United States prior to March 1, 1941				
(3) Obligations of all instrumentalities of the United States issued on or after March 1, 1941				
5. Other investments (itemize)				
6. Capital assets:				
(a) Depreciable assets (itemize in separate schedule)	$		$	
Less: Reserve for depreciation				
(b) Depletable assets	$		$	
Less: Reserve for depletion				
(c) Land				
7. Other assets (itemize)	$		$	
8. TOTAL ASSETS		$		$
LIABILITIES				
9. Accounts payable		$		$
10. Bonds, notes, and mortgages payable:				
(a) With original maturity of less than 1 year	$		$	
(b) With original maturity of 1 year or more				
11. Accrued expenses (itemize)	$		$	
12. Other liabilities (itemize)	$		$	
13. Surplus reserves (itemize in separate schedule)				
14. Capital stock: Number of shares at end of year—				
(a) Preferred stock ( )	$		$	
(b) Common stock ( )				
15. Paid-in or capital surplus				
16. Earned surplus and undivided profits				
17. TOTAL LIABILITIES		$		$

SCHEDULE B

Schedule M.—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Total distributions to stockholders charged to earned surplus during the taxable year:			13. Earned surplus and undivided profits at close of preceding taxable year (Schedule L)	$
(a) Cash	$		14. Adjusted net income (item 38, page 1)	
(b) Stock of the corporation			15. Nontaxable and partially exempt income:	
(c) Other property			(a) Interest on:	
2. Contributions (excess over 5 percent limitation)			(1) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	
3. Federal income and excess-profits taxes			(2) Obligations of the United States:	
4. Income taxes claimed as a credit in whole or in part in item 43, page 1			(i) Obligations issued on or before September 1, 1917; all postal savings bonds; Treasury notes issued prior to December 1, 1940; and Treasury bills issued prior to March 1, 1941	
5. Federal taxes paid on tax-free covenant bonds				
6. Excess of capital losses over capital gains				

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17. TOTAL LIABILITIES ... | | $ | $

Schedule M.—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Total distributions to stockholders charged to earned surplus during the taxable year:		
(a) Cash	$	
(b) Stock of the corporation		
(c) Other property		
2. Contributions (excess over 5 percent limitation)		
3. Federal income and excess-profits taxes		
4. Income taxes claimed as a credit in whole or in part in item 43, page 1		
5. Federal taxes paid on tax-free covenant bonds		
6. Excess of capital losses over capital gains		
7. Additions to surplus reserves (list separately):		
(a)		
(b)		
8. Other unallowable deductions:		
(a)		
(b)		
9. Adjustments not recorded on books (itemize):		
(a)		
(b)		
10. Sundry debits to earned surplus (itemize):		
(a)		
(b)		
11. Earned surplus and undivided profits at close of the taxable year (Schedule L)		
12. Total of lines 1 to 11	$	

SCHEDULE A

13. Earned surplus and undivided profits at close of preceding taxable year (Schedule L)	$	
14. Adjusted net income (item 38, page 1)		
15. Nontaxable and partially exempt income:		
(a) Interest on:		
(1) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia; or United States possessions		
(2) Obligations of the United States:		
(i) Obligations issued on or before September 1, 1917; all postal savings bonds; Treasury notes issued prior to December 1, 1940; and Treasury bills issued prior to March 1, 1941		
(ii) United States savings bonds and Treasury bonds owned in the principal amount of $5,000 or less, issued prior to March 1, 1941		
(iii) United States savings bonds and Treasury bonds owned in excess of the principal amount of $5,000 issued prior to March 1, 1941		
(3) Obligations of instrumentalities of the United States:		
(i) Obligations of Federal land banks, joint stock land banks, and Federal intermediate credit banks issued prior to March 1, 1941		
(ii) Obligations issued by other instrumentalities of the United States prior to March 1, 1941		
(b) Other nontaxable income (itemize):		
(1)		
(2)		
16. Charges against surplus reserves (itemize):		
17. Adjustments not recorded on books (itemize):		
18. Sundry credits to earned surplus (itemize):		
19. Total of lines 13 to 18	$	

EXCESS PROFITS TAX. (See Instructions for Form 1121)

(a) Is an excess profits tax return on Form 1121 being filed for the taxable period covered by this return? ... Yes

(b) If a personal service corporation (other than a member of an affiliated group of corporations filing a consolidated return) signifies below its desire not to be subject to the excess profits tax, it shall be exempt from such tax and the provisions of Supplement S, Chapter 1, shall apply to the shareholders in such corporation who were such shareholders on the last day of the taxable year of the corporation. (Attach Form 1121PS)

(c) If corporation claims exemption under section 727 of the Internal Revenue Code, state basis of claim ...

(d) If an excess profits tax return is not being filed for the reason that it is claimed that the excess profits net income computed under the invested capital method is not greater than (1) $10,000 for a taxable year ending in 1945, or (2) an amount equal to the sum of the portion of $10,000 applicable to the part of the year falling in 1945 and the portion of $25,000 applicable to the part of the year falling in 1946, in case of a taxable year beginning in 1945 and ending in 1946, the following Schedule N should be filled in. The completion of Schedule N does not constitute the filing of an excess profits tax return.

Schedule N.—EXCESS PROFITS NET INCOME COMPUTATION

1. Normal-tax net income (computed without credit for income subject to excess profits tax and dividends received credit) (item 28, page 1)	$	
2. Net short-term capital gain (do not enter net short-term capital loss)		
3. 30 percent of interest on borrowed capital		
4. Adjustment to net operating loss deduction under section 711 (a) (2) (L)		
5. Total of lines 1 to 4	$	
6. Dividends received credit adjustment (item 13, page 1, excluding the sum of (a) dividends received (actual or constructive) from foreign personal holding companies, and (b) dividends received on stock held primarily for sale to customers by a dealer in securities)		$
7. Net gain from sale or exchange of capital assets (item 12 (a), plus item 23, page 1)		
8. Income from retirement or discharge of bonds, etc.		
9. Refunds and interest on Agricultural Adjustment Act taxes		
10. Recoveries of bad debts		
11. Total of lines 6 to 10		$

12. Excess profits net income (for purpose of determining necessity for filing return) (line 5 minus line 11) ... $

16—41120-8

Computation proved

Form 1120 Treasury Department Internal Revenue Service

Fiscal Year

UNITED STATES
CORPORATION INCOME TAX RETURN

For Calendar Year 1946

or fiscal year beginning Nov. 1, 1946, and ending Oct. 31, 1947

3) 1946

FILED DEC 24 1947

Serial No. 4[illegible]

District Kentucky

PAID 17. DEC 24 1947

Collector's Office District of Kentucky Cash Check M. O.

First Payment $

[fol. 39]

2.76

PRINT PLAINLY CORPORATION'S NAME AND ADDRESS

The Colony, Inc. (Name)

145 East High St (Street and number)

Lexington (City or town, postal zone number) Ky (State)

Kind of business: Farm - Real Estate

Business group serial number (from Instruction N)

Number of places of business

NORMAL-TAX NET INCOME COMPUTATION

GROSS INCOME

1.	Gross sales (where inventories are an income-determining factor) $; Less: Returns and allowances $		
2.	Cost of goods sold. (From Schedule A)		
3.	Gross profit from sales		
4.	Gross receipts (where inventories are not an income-determining factor) $; Less: Cost of operations (From Schedule B)		
5.	By: J. R. Thompson		
6.	Gross profit, where inventories are not an income-determining factor		
7.	Interest on loans, notes, mortgages, bonds, bank deposits, etc		
8.	Interest on corporation bonds, etc $		
9.	(a) Interest on United States savings bonds and Treasury bonds owned in excess of the principal amount of $5,000 issued prior to March 1, 1941. (From Schedule M, line 19 (a) (2) (iii))		
	(b) Interest on obligations of certain instrumentalities of the United States issued prior to March 1, 1941. (From Schedule M, line 19 (a) (3) (ii))		
	(c) Interest on Treasury notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. (Submit schedule)		
10.	Rents		
11.	Royalties		
12.	(a) Excess of net short-term capital gain over net long-term capital loss. (From Schedule C)		
	(b) Excess of net long-term capital gain over net short-term capital loss. (From Schedule C)		
	(c) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule D)		
13.	Dividends. (From Schedule E)		
14.	Other income. (State nature)		
15.	Total income in items 3, and 6 to 14, inclusive. Schedule A		$ 18,095 41

THE TAX COURT OF THE U.S. DIV. 13 DOCKET 5368 ACQUIESCED IN OCT 26 1955 E

Rec'd with Return DEC 23 1947 61 Coll. Int. Rev. Dist. of Ky.

P 3/4/49 R.A.R. ATT'D TO

DEDUCTIONS

16.	Compensation of officers. (From Schedule F)	$	
17.	Salaries and wages (not deducted elsewhere)		
18.	Rent		
19.	Repairs		
20.	Bad debts. (From Schedule G)		
21.	Interest		
22.	Taxes. (From Schedule H)		
23.	Contributions or gifts paid. (From Schedule I)		
24.	Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule)		
25.	Depreciation. (From Schedule J)		
26.	Depletion of mines, oil and gas wells, timber, etc. (Submit schedule)		
27.	Net operating loss deduction. (Submit statement)		
28.	Amortization of emergency facilities. (Submit schedule)		
29.	(a) Advertising		
	(b) Amounts contributed under a pension, annuity, stock bonus, or profit-sharing plan, etc		
	(c) Other deductions authorized by law. (From Schedule K)		
30.	Total deductions in items 16 to 29, inclusive. Schedule A		18,053 38
31.	Net income (item 15 minus item 30)		$ 41 73
32.	Less: Interest on certain obligations of the United States and its instrumentalities issued prior to March 1, 1941. (Enter total of items 9 (a) and (b))		-0-
33.	Adjusted net income		$
34.	Less: Dividends received credit (85 percent of column 2, Schedule E, but not in excess of 85 percent of item 33, above)		-0-
35.	Normal-tax net income		$ 41 73

TOTAL INCOME TAX

36.	Total income tax (line 19, page 3)	$ 8 76	
37.	Less: Credit for income taxes paid to a foreign country or United States possession allowed a domestic corporation		
38.	Balance of income tax due		$ 8 76

AFFIDAVIT. (See Instruction E)

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder.

Subscribed and sworn to before me this 17th day of December, 1947

Hugh Mennitten President (Signature of officer (or other principal officer)) (Official title)

MY COMMISSION EXPIRES JUNE 4, 1950

NOTARIAL SEAL

Ann Lewin Swift Notary Public (Signature of officer administering oath) (Title)

CORPORATE SEAL

F. Hoge Jr. Treas. (Treasurer, Assistant Treasurer, or Chief Accounting Officer) (Official title)

AFFIDAVIT. (See Instruction E)

I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this 15 day of December, 1947

NOTARIAL SEAL

My Commission Expires [illegible] 1950

(Signature of officer administering oath) (Title)

Notary Public, Fayette County Ky.

(Signature of person preparing this return)

(Name of firm or employer, if any)

HIPNER AND FORTUNE

Certified Public Accountants

(Street and number, city or town, and State)

THE COLONY, INCORPORATED
Lexington, Kentucky
Schedules Submitted with Income Tax Return
Taxable Year Ended October 31, 1947

Schedule B - Balance Sheets as at

	October 31 1946	October 31 1947
ASSETS		
Cash in Bank	863.01	1,279.28
Accounts Receivable	71,631.25	42,535.21
Notes Receivable	-0-	13,487.46
First National Bank and Trust Co. Escrow Agent	52,891.25	21,076.29
Bosworth Farm - Land	72,282.88	72,282.88
The Colony Subdivision - Lots	74,175.00	55,600.00
Farm Buildings and Fencing	29,000.80	29,000.80
Farm Equipment	670.00	1,163.25
Live Stock	2,478.35	2,441.09
Total Assets	303,992.54	238,865.24
LIABILITIES		
Notes Payable - Bank Loans	149,403.00	122,767.58
Notes Payable - Stockholders	57,800.00	57,800.00
Accounts Payable	165.65	-0-
Reserve for Improvements	76,074.12	40,323.42
Reserve for Depreciation —	706.00	2,267.86
Accrued Federal Income Tax	4,589.84	8.76
Accrued Kentucky Income Tax	570.15	1.67
Accrued State and County Taxes	-0-	990.00
Surplus - Earned	13,683.68	13,685.37
Capital Stock, 400 Shares (No Par)	1,000.00	1,000.00
Total Liabilities	303,992.54	238,865.24

[illegible]

[illegible]

Farm Sales

Hogs		488.35
Cattle		4,901.13
Sheep, Lambs, Wool		502.85
Tobacco		8,737.33
Barley		1,203.92
Hay		297.83
Total		14,049.35
Less:		
Cost of Cattle Sold	3,840.65	
Cost of Sheep Sold	486.00	
1/8 of Tobacco to Bosworth Estate	1,127.89	5,454.54
Gross Profit - Farm		8,595.41
Sales of 9 Lots	28,075.00	
Less Cost of Lots Sold	19,575.00	
Gross Profits - Lots		9,500.00
Total Gross Revenue		18,095.41

DEDUCTIONS

Depreciation	1,561.86	
Taxes	1,934.65	
Interest	9,032.67	
Repairs	774.57	
Expenses General	5,049.93	
Total Deductions		18,053.68
Taxable Income		41.73
Deduct:		
Ky. Department of Revenue, Penalty	29.01	
Accrued Federal Income Tax	8.76	
Accrued Ky. Income Tax	1.67	39.44
Surplus Addition for Year		2.29
Add:		
Surplus Nov. 1, 1946		13,683.68
Surplus October 31, 1947		13,685.97

THE COLONY, INCORPORATED
Lexington, Kentucky
Schedules Submitted with Income Tax Return
Taxable Year Ended October 31, 1947

Schedule A-1 - Depreciation

Property	Cost	Rate	Depreciation Sustained Current	Prior	Total
5 Barns - 4-27-1946	23,000.00	5%	1,150.00	575.00	1,725.00
1 House "	3,500.00	5%	175.00	87.50	262.50
Re-habilitation above 1946	2,500.00	5%	125.00	-0-	125.00
2 Mules 5-16-1946	100.00	20%	20.00	10.00	30.00
Farm Equipment 1946	670.00	10%	67.00	33.50	100.50
Tractor Mower 7-23-1947 (1/4)	493.25	20%	24.66	-0-	24.66
Tools " (1/4)	8.25	10%	.20	-0-	.20
Totals			1,561.86	706.00	2,267.86

Schedule A-2 - Taxes

Stamps on Deeds	73.00
Ky. Corporation License	79.66
Bank Deposits	44.59
Sheriff, Fayette County	1,437.40
Total	1,634.65

Schedule A-3 - Interest

Ky. Dept. of Revenue	6.77
First National Bank & Trust Co.	9,025.86
Adjustment, Leet Notes	.04
Total	9,032.67

Schedule A-4 - Repairs

Repairs - Buildings	547.63
Repairs - Equipment	226.94
Total	774.57

Schedule A-5 - Expenses General

Advertising	230.60
Directors Expense	42.40
Fertilizer	6.00
Coke	205.05
Insurance	528.68
Salaries - Farm	794.72
Salaries - Clerical	431.80
Seed and Feed	878.22
Supplies and Expense - Farm	141.82
Do - Office	260.64
Telephone and Telegraph	6.76
Legal and Accounting	1,012.50
Gas and Oil	109.10
Miscellaneous Farm Expense	401.54
Total	5,049.93

INCOME TAX COMPUTATION. (See Tax Computation Instructions)

Line No.	NORMAL TAX COMPUTATION	Column 1	Col. 2 Rate	Column 3 Amount of Tax
	DOMESTIC CORPORATIONS WITH NORMAL-TAX NET INCOMES NOT OVER $50,000			
1.	Normal-tax net income (item 35, page 1)	$ 41 73		
2.	Portion of line 1 (not in excess of $5,000); and tax at 15 percent	$ 41 73	15%	$ 6 26
3.	Portion of line 1 (in excess of $5,000 and not in excess of $20,000); and tax at 17 percent		17%	
4.	Portion of line 1 (in excess of $20,000 and not in excess of $25,000); and tax at 19 percent		19%	
5.	Portion of line 1 (in excess of $25,000); and tax at 31 percent		31%	
6.	Total normal tax (total tax in column 3 of lines 2, 3, 4, and 5)			$ 6 26
	DOMESTIC CORPORATIONS WITH NORMAL-TAX NET INCOMES OF OVER $50,000 AND FOREIGN CORPORATIONS ENGAGED IN BUSINESS WITHIN THE UNITED STATES IRRESPECTIVE OF AMOUNT OF NORMAL-TAX NET INCOME			
7.	Normal-tax net income (item 35, page 1)	$		
8.	Normal tax (24 percent of line 7)		24%	$
	SURTAX COMPUTATION			
9.	Net income (item 31, page 1)	$		
10.	Less: Dividends received credit (85 percent of column 2, Schedule E, but not in excess of 85 percent of item 33, page 1 (excluding from the computation certain dividends received on preferred stock of a public utility))	$		
11.	Dividends paid on certain preferred stock if taxpayer is a public utility			
12.	Surtax net income	$		
	CORPORATIONS WITH SURTAX NET INCOMES NOT OVER $50,000			
13.	Portion of line 12 (not in excess of $25,000); and tax at 6 percent (or 8 percent in the case of a consolidated return)	$ 41 73	6%	$ 2 50
14.	Portion of line 12 (in excess of $25,000 and not in excess of $50,000); and tax at 22 percent (or 24 percent in the case of a consolidated return)		22%	
15.	Total surtax in column 3 of lines 13 and 14			$ 2 50
	CORPORATIONS WITH SURTAX NET INCOMES OF OVER $50,000			
16.	Surtax net income (line 12 above)	$		
17.	Surtax (14 percent of line 16) (or 16 percent in the case of a consolidated return)		14%	$
18.	Total normal tax and surtax (line 6 or 8, plus line 15 or 17, whichever is applicable)			$ 8 76
19.	Total tax (line 18, or line 20 of Schedule C)			$

QUESTIONS

1. Date incorporated 1945

2. State or country Ky.

3. If incorporated in 1946, indicate whether (a) completely new business ☐, or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate) . If successor to previously existing business, give name and address of the previous business organization

4. Collector's office where the corporation's return for the preceding year was filed Ky.

5. Enter amount of income (or deficit) from Item 34, page 1, Form 1120 for 1945 $

6. The corporation's books are in care of J. E. Marks

Located at Lexington, Ky.

7. Enter the approximate number of stockholders at the close of the taxable year 6

8. If the total of Line 1 of Schedule M, page 4, is less than 70% of the earnings and profits for the taxable year, state reasons for retention of such earnings and profits. (See Instruction J)

9. Indicate whether the corporation is a farmers' marketing or purchasing cooperative association ☐, or a consumers' cooperative association ☐

10. Is the corporation a personal holding company within the meaning of section 501 of the Internal Revenue Code? No (If so, an additional return on Form 1120 H must be filed.)

11. Is this a consolidated return? No (If so, procure from the collector of internal revenue for your district Form 851, Affiliations Schedule, which shall be filled in, sworn to, and filed as a part of this return.)

12. If this is not a consolidated return: (a) Did the corporation own at any time during the taxable year 50 percent or more of the voting stock of another corporation either domestic or foreign? No; or (b) did any corporation, individual, partnership, trust, or association own at any time during the taxable year 50 percent or more of the corporation's voting stock? No (If either answer is "yes," attach separate schedule showing: (1) Name and address; (2) percentage of stock owned; (3) date stock was acquired; and (4) the collector's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.)

13. Is this return made on the basis of cash receipts and disbursements? No If not, describe fully in separate statement. Accrual

14. Has the corporation in this return taken a deduction for any amount of wages or salaries representing an increase or decrease in rates *which required approval* in order to be deemed lawful under the Act of October 2, 1942, as amended, and regulations issued thereunder, or the establishment of rates in new plants or new departments requiring such approval? (Answer "yes" or "no") No If so, attach statement as required by Instructions 16 and 17.

15. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower None If other basis is used, explain fully in separate statement, giving date inventory was last reconciled with stock.

16. Did the corporation make a return of information on Forms 1096 and 1099 or Form W-2a for the calendar year 1946 (see Instruction G-(1))? No

17. Has any transaction described in Instruction G-(3) occurred on or after October 8, 1940? (Answer "yes" or "no") No

18. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? No (If so, attach statement as required by Instruction K-(3).)

16—69361-1

Schedule L.—BALANCE SHEETS. (See Instruction L)

ASSETS	Beginning of Taxable Year: Amount	Beginning of Taxable Year: Total	End of Taxable Year: Amount	End of Taxable Year: Total
1. Cash		$		$
2. Notes and accounts receivable	$		$	
Less: Reserve for bad debts				
3. Inventories:				
(a) Raw materials	$		$	
(b) Work in process				
(c) Finished goods				
(d) Supplies				
4. Investments in governmental obligations:				
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	$		$	
(b) Obligations of the United States:				
(1) Obligations issued on or before September 1, 1917; all postal savings bonds; Treasury notes issued prior to December 1, 1940; and Treasury bills issued prior to March 1, 1941				
(2) United States savings bonds and Treasury bonds issued prior to March 1, 1941				
(3) Treasury notes issued on or after December 1, 1940, and all other obligations of the United States issued on or after March 1, 1941				
(c) Obligations of instrumentalities of the United States				
(1) Obligations of Federal land banks, joint stock land banks, and Federal intermediate credit banks issued prior to March 1, 1941				
(2) Obligations issued by other instrumentalities of the United States prior to March 1, 1941				
(3) Obligations of all instrumentalities of the United States issued on or after March 1, 1941				
5. Other investments (itemize)	$		$	
6. Capital assets:				
(a) Depreciable assets (itemize)	$		$	
Total depreciable assets	$		$	
Less: Reserve for depreciation				
(b) Depletable assets	$		$	
Less: Reserve for depletion				
(c) Land				
7. Other assets (itemize)	$		$	
8. TOTAL ASSETS		$		$
LIABILITIES				
9. Accounts payable		$		$
10. Bonds, notes, and mortgages payable:				
(a) With original maturity of less than 1 year	$		$	
(b) With original maturity of 1 year or more				
11. Accrued expenses (itemize)	$		$	
12. Other liabilities (itemize)	$		$	
13. Surplus reserves (itemize)	$		$	
14. Capital stock: Number of shares at end of year—				
(a) Preferred stock ..... ( )	$		$	
(b) Common stock ..... ( )				
15. Paid-in or capital surplus				
16. Earned surplus and undivided profits				
17. TOTAL LIABILITIES		$		$

Schedule M.—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Total distributions to stockholders charged to earned surplus during the taxable year:		17. Earned surplus and undivided profits at close of preceding taxable year (Schedule L)	$
(a) Cash	$	18. Adjusted net income (item 33, page 1)	
(b) Stock of the corporation		19. Nontaxable and partially exempt income:	
(c) Other property		(a) Interest on:	
2. Contributions or gifts (excess over 5 percent limitation)		(1) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	
3. Federal income and excess profits taxes		(2) Obligations of the United States:	
4. Income taxes of foreign countries or United States possessions if claimed as a credit in whole or in part in item 37, page 1		(i) Obligations issued on or before September 1, 1917; all postal savings bonds, Treasury notes issued prior to December 1, 1940, and Treasury bills issued prior to March 1, 1941	
5. Federal taxes paid on tax-free covenant bonds		(ii) United States savings bonds and Treasury bonds owned in the principal amount of $5,000 or less, issued prior to March 1, 1941	
6. Special improvement taxes tending to increase the value of the property assessed		(iii) United States savings bonds and Treasury bonds owned in excess of the principal amount of $5,000 issued prior to March 1, 1941	
7. Replacements, renewals, and capital expenditures charged to expenses on the books		(3) Obligations of instrumentalities of the United States:	
8. Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary		(i) Obligations of Federal land banks, joint stock land banks, and Federal intermediate credit banks issued prior to March 1, 1941	
9. Unallowable interest incurred in purchasing or carrying exempt interest obligations		(ii) Obligations issued by other instrumentalities of the United States prior to March 1, 1941	
10. Excess of capital losses over capital gains		(b) Other nontaxable income (itemize)	
11. Additions to surplus reserves (list separately):		(1)	
(a)		(2)	
(b)		20. Charges against surplus reserves deducted from income in the return (itemize):	
(c)		(a)	
(d)		(b)	
12. Other unallowable deductions:		21. Adjustments for tax purposes not recorded on books (itemize):	
(a)		(a) Schedule A	
(b)		(b)	
13. Adjustments for tax purposes not recorded on books (itemize):		22. Sundry credits to earned surplus (itemize):	
(a)		(a)	
(b)		(b)	
14. Sundry debits to earned surplus (itemize):		(c)	
(a)		23. Total of lines 17 to 22	$
(b)			
(c)			
15. Earned surplus and undivided profits as shown by balance sheet at close of the taxable year (Schedule L)			
16. Total of lines 1 to 15	$		

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16—62681-1 ★ U. S. GOVERNMENT PRINTING OFFICE

[fol. 46] MINUTE ENTRY OF ARGUMENT AND SUBMISSION—April 10, 1957 (omitted in printing).

IN UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

JUDGMENT—Filed April 22, 1957

The sole question on this review is whether the five-year statute of limitations contained in section 275(c) of the Internal Revenue Code of 1939 was applicable in this case, as the Tax Court held.[1]

The petitioner is a corporation dealing in real estate. Its income tax returns for the years in question contained understatements of gross income of more than twenty-five per cent resulting from an erroneous overstatement of the [fol. 47] basis of land sold, rather than from any omission of gross receipts. Under these circumstances it is the petitioner's contention that the general three-year limitation period of section 275 (a) of the 1939 Code is applicable. As petitioner's counsel correctly points out, the decisions of the Courts of Appeals of several other circuits give clear support to this view. *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. (2d) 570 (3 Cir., 1953); *Deakman-Wells Co.* v. *Commissioner*, 213 F. (2d) 894 (3 Cir., 1954); *Goodenow* v. *Commissioner*, 238 F. (2d) 20 (8 Cir., 1956); cf. *Slaff* v. *Commissioner*, 220 F. (2d) 65 (9 Cir., 1955); *Davis* v. *Hightower*, 230 F. (2d) 549 (5 Cir., 1956).

The reasoning of these cases is not without considerable persuasive force, and if the question were here for the first time, we might be disposed to follow them. However, the question has already been decided by this court in *Reis* v. *Commissioner*, 142 F. (2d) 900 (6 Cir., 1944), where it was held that the five-year limitation was applicable when the taxpayer's understatement of gross income of more than twenty-five per cent was the result of his overstatement of

---

[1] "(c) Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

the cost basis of property sold. The facts in the *Reis* case are, of course, not identical with the facts in the present case, but the issue presented is the same.

Upon the authority of *Reis* v. *Commissioner* the decision of the Tax Court is affirmed.

[fol. 48] Clerk's Certificate (omitted in printing).

[fol. 49] SUPREME COURT OF THE UNITED STATES
No. 306, October Term, 1957

THE COLONY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI—October 14, 1957

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Whittaker took no part in the consideration or decision of this application.

Clerk, Supreme Court, U.S.
FILED
JUL 3 1957
JOHN T. FEY, Clerk

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1956

No. 306

THE COLONY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BERNARD H. BARNETT,
RICHARD C. OLDHAM,
Attorneys for Petitioner.

WESTERFIELD-BONTE CO., INCORPORATED, LOUISVILLE, KY.

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Text of Statutes Involved.

INTERNAL REVENUE CODE OF 1939:

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION

Except as provided in section 276—

(a) General Rule—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

(c) Omission from Gross Income—If the taxpayer omits from gross income the amounts properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

SEC. 276. SAME—EXCEPTIONS

(b) Waiver—Where before the expiration of the time prescribed in section 275 for the assessment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

INTERNAL REVENUE CODE OF 1954:

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(e) Omission from Gross Income—

Except as otherwise provided in subsection (c)—

(1) INCOME TAXES.—In the case of any tax imposed by subtitle A—

LIST OF AUTHORITIES.

Cases: PAGE

Davis v. Hightower, 230 F. 2d 549 6

Deakman-Wells Co. v. Commissioner, 213 F. 2d 894 6

John E. Goodenow v. Commissioner, 238 F. 2d 20 6

Slaff v. Commissioner, 220 F. 2d 65 6

Uptegrove Lumber Co. v. Commissioner, 204 F. 2d 570 6

Statutes:

Section 275 (a) of the Internal Revenue Code of 1939, 26 U. S. C. § 275 (a) 4

Section 275 (c) of the Internal Revenue Code of 1939, 26 U. S. C. § 275 (c) 2–3

Section 276 (b) of the Internal Revenue Code of 1939, 26 U. S. C. § 276 (b) 4

Section 6501 (e) of the Internal Revenue Code of 1954, 26 U. S. C. § 6501 (e) 10

Section 7851 (d) of the Internal Revenue Code of 1954, 26 U. S. C. § 7851 (d) 10

Miscellaneous:

Revised Rules, Supreme Court of the United States, Rule 19 (1) (b) 6

Vincent, C. J., Address Before American Bar Association, September 7, 1949 6

Reis v. Commissioner, 142 F. 2d 900 6

(A) GENERAL RULE—If the taxpayer omits from gross income an amount property includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

SEC. 7851. APPLICABILITY OF REVENUE LAWS.

(d) Periods of Limitation—

All periods of limitation, whether applicable to civil causes and proceedings, or to the prosecution of offenses, or for the recovery of penalties or forfeitures, hereby repealed shall not be affected thereby, but all suits, proceedings, or prosecutions, whether civil or criminal, for causes arising, or acts done or committed, prior to said repeal, may be commenced and prosecuted within the same time as if this title had not been enacted.

IN THE

Supreme Court of the United States

October Term, 1957.

No. _____.

THE COLONY, INC., - - - - - - *Petitioner,*

v.

THE COMMISSIONER OF INTERNAL REVENUE, - - - - - - - *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment herein of the United States Court of Appeals for the Sixth Circuit.

OPINIONS BELOW.

The opinion and judgment of the Court of Appeals is printed in the Appendix hereto (App. 13-16). It is reported in 244 F. 2d 75. The opinion of the Tax Court of the United States is printed in the Appendix hereto (App. 17). It is reported in 26 T. C. No. 3.

OPINIONS AND JUDGMENTS BELOW.

UNITED STATES COURT OF APPEALS
For the Sixth Circuit
No. 13,008

The Colony, Inc., - - - - - - Petitioner,

v.

Commissioner of Internal Revenue, - - - Respondent.

Appeal from the Tax Court of the United States

April 22, 1957

Richard C. Oldham and Baldwin C. Barnam, Louisville, Kentucky, for petitioner.

Charles K. Rice, John Potts Barnes, Lee A. Jackson, Robert N. Anderson, Grant M. Wiprud, John M. Morawski, and Marvin W. Weinstein, Washington, D. C. for respondent.

Before McAllister, Miller and Stewart, Circuit Judges. Per Curiam.

The sole question on this review is whether the five year statute of limitations contained in section 275(c) of the Internal Revenue Code of 1939 was applicable in this case, as the Tax Court held.[1]

[1] "(c) Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

JURISDICTION.

The judgment of the Court of Appeals was entered on April 22, 1957 (App. 15-16). No petition for rehearing was filed. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED.

Is the 5-year statute of limitations under Section 275 (c), of the Internal Revenue Code of 1939, 26 U.S.C. Section 275 (c), applicable where the petitioner fully reported on its income tax returns all of its gross receipts from the sale of land and improvements, but where the Commissioner of Internal Revenue disallowed certain improvement costs, thereby reducing petitioner's cost basis of the land and improvements, which disallowance resulted in an increase in petitioner's gross profit in an amount in excess of 25% of the gross profit reported?

STATUTES INVOLVED.

The full text of Section 275 (c) of the Internal Revenue Code of 1939, 26 U.S.C. Section 275 (c), is as follows:

> "SEC. 275—PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.
>
> * * * * * * *
>
> (c) Omission from Gross Income.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25%

That petitioner is a corporation dealing in real estate. Its income tax returns for the years in question contained understatements of gross income of more than twenty-five percent resulting from an erroneous overstatement of the basis of land sold, rather than from any omission of gross receipts. Under these circumstances it is the petitioner's contention that the general three-year limitation period of section 275 (a) of the 1939 Code is applicable. As petitioner's counsel correctly points out, the decisions of the Courts of Appeals of several other circuits give clear support to this view. *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570 (3 Cir., 1953); *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894 (3 Cir., 1954); *Goodenow* v. *Commissioner*, 238 F. 2d 20 (8 Cir., 1956); cf. *Slaff* v. *Commissioner*, 220 F. 2d 65 (9 Cir., 1955); *Davis* v. *Hightower*, 230 F. 2d 549 (5 Cir., 1956).

The reasoning of these cases is not without considerable persuasive force, and if the question were here for the first time, we might be disposed to follow them. However, the question has already been decided by this court in *Reis* v. *Commissioner*, 142 F. 2d 900 (6 Cir., 1944), where it was held that the five-year limitation was applicable when the taxpayer's understatement of gross income of more than twenty-five percent was the result of his overstatement of the cost basis of property sold. The facts in the *Reis* case are, of course, not identical with the facts in the present case, but the issue presented is the same.

Upon the authority of *Reis* v. *Commissioner* the decision of the Tax Court is affirmed.

of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within five years after the return was filed."

STATEMENT.

Petitioner is a corporation organized and existing under the laws of the Commonwealth of Kentucky with principal office and place of business at Fayette County, Kentucky. Its principal business consists of the development and sale of lots in a subdivision called "The Colony." In 1945 it acquired unimproved land for this purpose and commenced the development thereof, which included, among other things, the construction of a water supply system at a cost of approximately $33,000. Lots from said land were sold in each of the petitioner's taxable years ended October 31, 1946, October 31, 1947, and October 31, 1950.

All gross receipts from the sale of such lots were fully reported in petitioner's federal income tax returns for each of said years. In arriving at its gross profit from these sales, petitioner used a cost basis for the lots sold which included certain items of development expense, including a portion of the cost of the construction of the water supply system. Upon subsequent examination of petitioner's income tax returns, the Commissioner of Internal Revenue determined that certain of the development expenses, including the cost of constructing the water supply system, were not properly includible in the cost basis of the land sold.

OPINION OF THE TAX COURT.

THE COLONY, INC., PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 53681. Filed April 9, 1956.

1. The petitioner is a corporation organized to acquire, subdivide, and sell real estate. It was organized with a total capital of $1,000. It obtained bank loans, secured by liens on its real estate, in an amount in excess of $149,000. Five of petitioner's stockholders paid over a total of $57,800 to petitioner and received petitioner's interest bearing promissory notes in that amount. *Held*, the $57,800 paid over to petitioner by its stockholders constituted contributions to capital, rather than bona fide loans, and amounts paid by petitioner to the stockholders in 1948, 1949, and 1950 constituted nondeductible distributions in the nature of dividends rather than interest on indebtedness which is deductible under section 23 (b) of the 1939 Code.

2. In determining its basis for gain or loss in the subdivision lots which it sold in 1946, 1947, and 1950, the petitioner added to its cost of the lots a pro rata portion of improvement expenses which it incurred or estimated that it would incur in developing the subdivision. *Held*, the cost of a water supply system which petitioner continued to own and operate during the taxable years did not constitute a development expense which could be added to petitioner's basis in the subdivision lots; *held, further*, petitioner's basis in the subdivision lots includes the amount of payments made by petitioner to two utility companies to induce the latter to extend their services to petitioner's subdivision; *held, further*, the respondent's determination that petitioner overestimated

its development expenses in the amount of $5,590.32 is sustained.

3. For the taxable years ended October 31, 1946, and October 31, 1947, the petitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the gross income stated in its returns. The understatements of gross income resulted from overstatements of cost of goods sold, rather than from omissions of gross receipts. *Held*, the 5-year statute of limitations contained in section 275 (c) of the 1939 Code is applicable, and the deficiencies determined for the years ended October 31, 1946, and October 31, 1947, are not barred. *Estate of J. W. Gibbs, Sr.*, 21 T. C. 443, followed.

Andrew W. Duncan, Esq., and *Don S. Sturgill, Esq.*, for the petitioner.

James F. Shea, Esq., for the respondent.

The Commissioner determined deficiencies in income tax and excess profits tax as follows:

Year ended October 31	Income tax	Excess profits tax
1946	$7,988.72	$2,356.71
1947	1,194.29	.....
1948	987.31	.....
1950	224.23	.....

The year ended October 31, 1949, also is involved because the amount of net operating loss sustained in that year will determine the amount of net operatnig loss deduction allowable for the year ended October 31, 1947. The issues to be decided are: (1) Whether payments made by petitioner to its shareholders in the amounts of $8,988.41, $3,468, and $3,468, in the taxable years ended October 31, 1948, 1949, and 1950, respectively, were deductible by petitioner as interest payments, or whether such payments were nondeductible distributions in the nature of divi-

The Commissioner's aforesaid determination of deficiencies was mailed to the petitioner within an extended period provided in waivers which petitioner executed more than three years but less than five years after the returns for the taxable years ended October 31, 1946, and October 31, 1947 were filed.[1] Petitioner duly and timely filed its petition to the Tax Court of the United States protesting the deficiency determination on the ground, *inter alia,* that the expiration of the general three year period of limitations provided for in Section 275 (a) of the Internal Revenue Code of 1939 (App. 13-14) barred the assessment of the alleged deficiencies in taxes.

PROCEEDINGS IN THE TAX COURT.

The Tax Court substantially sustained the Commissioner on the merits as to the disallowance of a portion of the cost basis claimed in respect of the lots sold during the taxable years ended October 31, 1946 and October 31, 1947 (see Issue 2, Tax Court Opinion, App. 38-45). Furthermore, the Tax Court held that the 5-year statute of limitations contained in Section 275 (c) of the Internal Revenue Code of 1939 was applicable, and that the assessment of the deficiencies determined for said years was not barred.

---

[1] A waiver, to be valid, must be executed prior to the expiration of the period of limitations. See Section 276(b) of the Internal Revenue Code of 1939, 26 U. S. C. 276(b) (App. 13). Accordingly, the execution of the waiver in this case did not serve to extend the general three-year statute of limitations provided for in Section 275(a) of the Internal Revenue Code of 1939, 26 U. S. C. 275(a).

dends; (2) whether petitioner's cost of subdivision lots includes the expenditures made to construct a water supply for the subdivision and the payments made to public utilities in order to induce the utilities to extend their service to the subdivision; and (3) whether the deficiencies determined for the years ended October 31, 1946, and October 31, 1947, are barred by the statute of limitations.

FINDINGS OF FACT.

The petitioner is a corporation organized under the laws of the State of Kentucky. Petitioner kept its books and filed its returns on an accrual method for fiscal years ended October 31. Petitioner's returns for the taxable years were filed with the collector of internal revenue for the district of Kentucky.

The petitioner's principal business is the development and sale of lots in a subdivision called "The Colony," which is located outside the city limits of Lexington, Kentucky. The petitioner also owned a water supply and distribution system, and beginning in 1949, sold water to houses which were built in the subdivision.

Issue 1. Deduction of Payments to Stockholders.

The petitioner was incorporated on or about November 14, 1945. Its authorized capital stock, which was all issued, consisted of 400 shares of capital stock without par value. Its paid-in capital was $1,000, or $2.50 per share of capital stock.

On or about April 19, 1946, Hugh Meriwether, L. J. Blakely, and Charles Sturgill, as owners of all of the petitioner's stock, entered into an agreement with Dr. Halbert Leet. The agreement recited that Dr. Leet agreed to lend petitioner, on petitioner's note, the sum of $17,500 for 5 years with interest at 6 per cent, payable semiannually; that Meriwether, Blakely, and Sturgill agreed that

PROCEEDINGS IN THE COURT OF APPEALS.

Petitioner duly and timely appealed to the Court of Appeals for the Sixth Circuit on the sole question of whether the 5-year statute of limitations contained in Section 275 (c) of the Internal Revenue Code of 1939 was applicable in respect of the deficiencies determined for the taxable years ended October 31, 1946 and October 31, 1947.

The Court of Appeals affirmed the Tax Court on question, stating in part as follows:

> ". . . it is the petitioner's contention that the general three-year limitation period of section 275 (a) of the 1939 Code is applicable. As petitioner's counsel correctly points out, the decisions of the Courts of Appeals of several other circuits give clear support to this view. *Uptegrove Lumber Co.* v. *Commissioner,* 204 F. 2d 570 (3 Cir., 1953); *Deakman-Wells Co.* v. *Commissioner,* 213 F. 2d 894 (3 Cir., 1954); *Goodenow* v. *Commissioner,* 238 F. 2d 20 (8 Cir., 1956); cf *Slaff* v. *Commissioner,* 220 F. 2d 65 (9 Cir., 1955); *Davis* v. *Hightower,* 230 F. 2d 549 (5 Cir., 1956).
>
> "The reasoning of these cases is not without considerable persuasive force, and if the question were here for the first time, we might be disposed to follow them. However, the question has already been decided by this court in *Reis* v. *Commissioner,* 142 F. 2d 900 (6 Cir., 1944), where it was held that the five-year limitation was applicable when the taxpayer's understatement of gross income of more than twenty-five per cent was the result of his overstatement of the cost basis of property sold. The facts in the *Reis* case are, of

they would convey to Dr. Leet, without further consideration, 10 per cent of petitioner's stock, that is, 40 shares; and that no dividends would be paid by petitioner without Dr. Leet's consent until the note was paid. The agreement between Dr. Leet and petitioner's shareholders provides, in part, as follows:

> This memorandum of agreement between Hugh Meriwether, L. J. Blakely and Charles Sturgill, of Lexington, Ky., owners of the capital stock of the Kentucky corporation The Colony, parties of the first part, hereinafter called the "Stockholders," and Dr. Halbert Leet, of Lexington, Ky., party of the second part, hereinafter called "Dr. Leet," witnesseth that it is agreed by and between the parties hereto as follows:
>
> Dr. Leet shall lend to the said corporation, The Colony on or before the 25th day of April, 1946, the sum of Seventeen Thousand Five Hundred Dollars ($17,500.00) upon the latter's negotiable promissory note in the said sum of money to be dated the day said loan is made, and to be payable on or before five years after date, with interest thereon at the rate of 6% per annum, payable semi-annually, from its date until its payment.
>
> The Stockholders shall, at the same time with the making of said loan, cause the said corporation to execute and deliver said note to Dr. Leet, and will assign and transfer to Dr. Leet as his own—without further consideration—ten per cent (10%) of the capital stock of said corporation; and they, and their successors, if any, in the ownership of their respective shares of stock of said corporation, shall see to it that no dividend is paid by said corporation, (except with the consent of Dr. Leet or his successors in ownership of said 10% of the stock) until said note (and any similar note issue or to be issued by the corporation under similar circumstances) shall have been paid.

On April 24, 1946, Dr. Leet paid $17,500 to petitioner in exchange for its note, and received 40 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. On the same day, L. B. Shouse also paid $17,500 to petitioner

course, not identical with the facts in the present case, but the issue presented is the same.

"Upon the authority of *Reis* v. *Commissioner* the decision of the Tax Court is affirmed."

REASONS FOR GRANTING THE WRIT.

The Decision Below Is in Direct and Irreconcilable Conflict With the Decisions of the Courts of Appeal for the Third Circuit, Eighth Circuit, Ninth Circuit, and Fifth Circuit.

The decision of the Court below on the interpretation to be given to Section 275 (c) of the internal Revenue Code of 1939 can not possibly be reconciled with the decisions of the Third Circuit in *Uptegrove Lumber Co.* v. *Commissioner,* 204 F. 2d 570 (1953), and *Deakman-Wells Co., Inc.* v. *Commissioner,* 213 F. 2d 894 (1954); and the decision of the Eighth Circuit in *John E. Goodenow* v. *Commissioner,* 238 F. 2d 20 (1956). Although arising on different facts, the Sixth Circuit's decision in this case is in irreconcilable conflict with the interpretation of Section 275 (c) of the 1939 Code adopted by the Ninth Circuit in *Slaff* v. *Commissioner,* 220 F. 2d 65 (1955), and the Fifth Circuit in *Davis* v. *Hightower,* 230 F. 2d 549 (1956).

The conflict on this important question of federal law is direct. It is precisely the type of conflict which this Court recognizes under its Rule 19(1) (b) pursuant to its purpose "to secure the national rights and uniformity of Judgmts".[2]

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[2] Address of the late Chief Justice Vinson before the American Bar Association, September 7, 1949, quoting from Statement of John Rutledge of South Carolina during debates before the Constitutional Convention.

in exchange for its note, and received 40 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. Also, on the same day, Meriwether, Blakely, and Sturgill each paid $7,600 to petitioner in exchange for similar promissory notes. The total amount received by petitioner on April 24, 1946, from the five individuals in exchange for its notes was $57,800. The notes issued by petitioner stated that repayment was to be made in 5 years, that is, on April 24, 1951, and that interest was payable at the rate of 6 per cent.

Prior to the end of petitioner's first fiscal year, on October 31, 1946, petitioner also issued notes in the amount of $149,403 to banks. The notes held by the banks were secured by liens on petitioner's real estate.

Also, prior to October 31, 1946, Gilmore N. Nunn acquired 4 shares of petitioner's stock from Meriwether, Blakely, and Sturgill. On October 31, 1946, petitioner's stock and notes payable were held as follows:

Name	Shares of petitioner's stock	Investment in stock at $2.50 per share	Face amount of petitioner's notes
Hugh Meriwether	105⅓	$ 263.34	7,600
L. J. Blakely	105⅓	263.33	7,600
Charles Sturgill	105⅓	263.33	7,600
Dr. Halbert Leet	40	100.00	17,500
L. B. Shouse	40	100.00	17,500
Gilmore N. Nunn	4	10.00	.....
Total—shareholders only	400	$1,000.00	$ 57,800
Banks	.....	.....	149,403
Total	400	$1,000.00	$207,203

The notes described above are reflected in the balance sheet attached to petitioner's return for the year ended October 31, 1946, as "Notes Payable—Bank Loans" in the amount of $149,403, and "Notes Payable—Stockholders" in the amount of $57,800.

In the *Uptegrove* case, *supra*, the taxpayer, a manufacturing corporation, reported all of its gross sales. From that figure it subtracted the "cost of goods sold" in arriving at the gross profit reported on its tax return. The Commissioner and the Courts agreed that the taxpayer overstated the cost items resulting in an understatement of its gross profit by more than 25% of the gross profit reported on its tax return. In reversing the Tax Court, the Court of Appeals for the Third Circuit meticulously traced the legislative history of Section 275(c) of the Internal Revenue Code of 1939 and concluded that it did not apply. The deficiency determinations made by the Commissioner were held to be barred by the expiration of the general three-year period of limitations. In arriving at its conclusion, the Appeals Court stated as follows:

> ". . . we think it was the manifest purpose of Congress to make an exception to the three year statute of limitation which would apply only to situations where the taxpayer had failed to make a return of some taxable gain".

Thus, the Court of Appeals for the Third Circuit stated, in effect, that Section 275 (c) means what it says; that the extended five year statute of limitations does not apply unless the taxpayer "omits" items of income. In the instant case, as in the *Uptegrove* case, no items of income were "omitted"—the petitioner merely overstated the cost basis of the property sold during the years in question.

None of the notes held by the stockholders has been paid by the petitioner with the exception of the note in the face amount of $17,500 issued to L. B. Shouse. At the time this note was paid, petitioner also purchased Shouse's 40 shares of stock at a price of $2.50 per share, or a total of $100. Sometimes after the taxable year, in 1953, Sturgill and the Central Rock Company, a corporation, acquired the stock and notes of petitioner held by the remaining stockholders, namely, Meriwether, Blakely, Dr. Leet, and Nunn. Sturgill and the Central Rock Company now own, equally, all of petitioner's outstanding stock, and the notes in the face amount of $40,300 which remain outstanding.

In the taxable years ended October 31, 1946, and October 31, 1947, the petitioner did not pay to the holders, or accrue on its books, or claim deductions on its returns for, any amounts payable as interest on the notes held by its stockholders. In the taxable year ended October 31, 1948, the petitioner paid a total of $8,988.41 to the five stockholder-noteholders, and claimed a deduction in that amount in its return for interest paid. The total amount of $8,988.41 purportedly was distributed in payment of the interest due on the notes for the 3 years ended October 31, 1946, 1947, and 1948, as follows:

Name	Payments for years ended October 31			Total paid
	1946	1947	1948	
Leet	$ 525.00	[1]$1,081.50	[1]$1,114.90	$2,721.40
Shouse	525.00	[1]1,081.50	[1]1,114.90	2,721.40
Blakely	228.00	[1]469.68	[1]484.19	1,181.87
Meriwether	228.00	[1]469.68	[1]484.19	1,181.87
Sturgill	228.00	[1]469.68	[1]484.19	1,181.87
Totals	$1,734.00	$3,572.04	$3,682.37	$8,988.41

[1]Six per cent interest on $17,500, the face amount of the notes held by Leet and Shouse, is $1,050 per year. Six per cent interest on $7,600, the face amount of the notes held by Blakely, Meriwether, and Sturgill, is $456.00. The difference between these amounts and the somewhat larger amounts actually paid, as set forth above, is not explained in the record.

In *Deakman-Wells Co. Inc., supra,* the Court of Appeals for the Third Circuit reaffirmed its decision in *Uptegrove,* stating, in part, as follows:

> "We recently had occasion to consider the scope of that subsection in Uptegrove Lumber Co. v. Commissioner of Internal Revenue, 3 Cir., 1953, 204 F. 2d 570. In that case we pointed out that the statute applies only where the taxpayer has failed to make a return of some taxable gain, where he has altogether omitted an item from the income reported, and not to a case such as this where he merely understates the final figure in his gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure. We adhere to the views which we expressed in the Uptegrove case and conclude that the Tax Court erred in holding section 275(c) applicable".

The Eighth Circuit was confronted with indistinguishable facts from those present in the above cited cases in *Goodenow, supra.* In rendering its decision, the Court stated, in part, as follows:

> "This Court has repeatedly ruled, particularly in tax cases, where uniformity of decision among the Circuits is vitally important, that the decision of a Court of Appeals of another Circuit should be followed unless demonstrably erroneous or unsound. See Birmingham v. Geer, 8 Cir., 185 F. 2d 82, 85 and cases cited, certiorari denied 340 U. S. 951, 71 S. Ct. 571, 95 L. Ed. 686; Commissioner of Internal Revenue v. Moran, 8 Cir., 236 F. 2d 595, 596.

In each of the taxable years ended October 31, 1949, and October 31, 1950, the petitioner paid $3,468 to the five stockholder-noteholders, and claimed deductions in that amount in its returns for each of the years for interest paid.

The respondent disallowed the entire amount claimed by petitioner as interest deductions in its returns for the taxable years ended October 31, 1948, 1949, and 1950. The deficiency notice contains the following explanation for the disallowance of the interest deduction claimed in petitioner's return for the year ended October 31, 1948:

It is held that the amount of $8,988.41 deducted as interest in the return filed for the fiscal year ended October 31, 1948, constitutes dividends within the purview of Section 115 of the Internal Revenue Code, and is therefore not allowable as a deduction in computing net taxable income.

Similar explanations are given for the disallowance of the interest deductions claimed in the returns for the years ended October 31, 1949, and October 31, 1950.

Except for items representing the notes payable to stockholders and to banks, and reserve accounts for depreciation and for improvements, the following are the only liabilities set forth in the balance sheets attached to petitioner's returns for the years ended October 31, 1946, to October 31, 1950, inclusive:

	Year ended October 31				
	1946	1947	1948	1949	1950
ccounts payable	$ 165.65	.....	.....	.....	.....
ccrued taxes	5,160.09	$1,000.43	$4,033.84	$986.94	$1,004.48
Total	$5,325.74	$1,000.43	$4,033.84	$986.94	$1,004.48

> "The decision of the Court of Appeals for the Third Circuit in the Uptegrove Lumber Co. case we regard as sound and logical. There is, we think, no reason why it should be rejected by this Court."

In *Slaff, supra,* the taxpayer received income for services performed while overseas. In his tax return, under the heading "Income", he noted the receipt of income and then stated that such income was exempt from taxation. The Court of Appeals for the Ninth Circuit held that there were no "omissions", and that it was in full accord with the interpretation of Section 275 (c) adopted by the Court of Appeals for the Third Circuit in *Uptegrove* and *Deakman-Wells.* Accordingly, it held the extended period of limitations provided for by 275 (c) inapplicable.

In *Davis* v. *Hightower, supra,* the taxpayer, on "Schedule D—Gains and Losses from Sales or Exchanges, Capital Assets, etc." reported the full amount of claimed capital gains. Fifty percent (50%) of said gains were carried forward to the face of the tax return form (Form 1040). In holding that Section 275 (c) was inapplicable, the Court of Appeals for the Fifth Circuit stated, in part, as follows:

> "The two cases decided by the Court of Appeals for the Third Circuit recognize that either construction could be placed on this statute, and largely on the basis of the legislative history, it makes the test the question whether a specific item of income has been completely omitted from the return. To this legislative history is now added

The $57,800 paid to petitioner by the five shareholders in 1946 in return for petitioner's promissory notes constituted contributions to petitioner's capital rather than bona fide loans. The payments in the fiscal years ended October 31, 1948, 1949, and 1950, to the five stockholder-noteholders in the amounts of $8,988.41, $3,468, and $3,468, respectively, did not represent payments of interest.

Issue 2. Cost of Subdivision Lots to Petitioner.

Shortly after its organization, petitioner acquired a farm near Iexington, Kentucky. The farm was approximately 228 acres in size, and was acquired by petitioner for the purpose of subdivision into residential lots. The petitioner's plan of operation was to sell lots to individual buyers, rather than to construct and sell homes. The petitioner sold lots in each of the years ended October 31, 1946, 1947, and 1950.

For the purposes of reporting gain from the sale of lots, petitioner included as part of its cost or other basis in the lots a proportionate part of the estimated cost of developing the subdivision. The amount of estimated development expenses added by petitioner to its cost of the lots was $93,074.61, and the total basis claimed by petitioner in the subdivision amounted to $131,550. As is more fully set forth hereinafter, the respondent determined that the amount of development costs which were includible in the computation of petitioner's cost or other basis in the lots did not exceed $44,988.55, and that petitioner's total basis in the subdivision did not exceed $83,463.94. The amount of development expenses claimed by petitioner which was disallowed by respondent, $48,086.06, represents the following three items: The portion of the original estimated cost of development, $93,074.61, which petitioner had not expended as of September 30, 1950; the expenditures made by petitioner to acquire a water supply system;

> the amendment contained in the 1954 Internal Revenue Code, under the terms of which it is now clear that the inclusion of the statement made by appellee in his return here would be sufficient to prevent application of the five year statute. In view of the confusion as to the meaning of the statute prior to the adoption of the 1954 Code, we think it plain that the new language was enacted to clarify the existing law. On logic as well as precedent, therefore, we find that the full and complete statement by the taxpayer of every gross item of income and gain received by him as required by the return itself, rebuts the contention of the Commissioner that the five year statute applies to this case."
>
> (Footnotes 6 and 7 omitted.)

As indicated in the above excerpt from *Davis* v. *Hightower*, Congress, in enacting the Internal Revenue Code of 1954, adopted the interpretation of Section 275.(c) of the 1939 Code enunciated by all Courts of Appeal which had passed upon the question, exclusive of the Court of Appeals for the Sixth Circuit. See Section 6501 (e) of the Internal Revenue Code of 1954 (App. 13). However, Section 6501 (e) of the 1954 Code is not applicable for tax years ending prior to January 1, 1954. See Section 7851 (d) of the Internal Revenue Code of 1954 (App. 14).

The federal income tax touches the lives of nearly all of the citizens of the United States. It must be uniformily administered.

The decision of the Court in the case below stands alone among the decisions of the Courts of the various

and the amount of payments made by petitioner to two utility companies. The amount of each of the three items is as follows:

Unexpended part of estimated development costs	$ 5,590.82
Expenditures for water supply system	33,781.70
Payments to utility companies	8,713.54
Total	$48,086.06

The first part of petitioner's real estate to be subdivided was The Colony, which comprised about 65 lots covering approximately 60 acres. When subdivision of The Colony began, there was no available source of water. Without water, the lots would not have been salable. The petitioner was advised that it would cost between $40,000 to $60,000, and perhaps more, to connect The Colony with the facilities of the Lexington Water Company, which were approximately 1½ miles away. The petitioner's stockholders decided that petitioner would construct a water system to provide water to lot purchasers instead of entering into any arrangement with the Lexington Water Company. Prior to 1949, the petitioner completed a water supply and distribution system for The Colony. The chief source of water for the system is a well capable of producing 576,000 gallons of water each 24 hours. Water from the well is pumped automatically by turbine pump through a chlorination tank to a 55,000-gallon capacity concrete pool, and then, by highlift pumps, into a 3,000-gallon capacity steel pneumatic tank. For convenience, the portion of the water system described above is referred to as the pumping system. From the pneumatic tank, the water passes into the "distribution system," which consists of 6,500 feet of 4- and 6-inch pipe, about 2,500 feet of 2-inch pipe, and meters to the various houses.

Circuits. Unless this Court assumes jurisdiction and settles the principle of law involved in this case, petitioner, and the citizens of the States of Ohio, Michigan, Tennessee, and Kentucky, will be treated differently from the citizens of the various other States.

CONCLUSION.

The decision below presents the strongest possible reasons for review by this Court.

It is in direct and irreconcilable conflict with the decisions of the Courts of Appeal for the Third Circuit, Eighth Circuit, Ninth Circuit, and Fifth Circuit.

We respectfully submit that we can not have one law for taxpayers in the Sixth Circuit and an opposite law for all other taxpayers.

For the foregoing reasons this petition for certiorari should be granted.

Respectfully submitted,

BERNARD H. BARNETT,
RICHARD C. OLDHAM,
Attorneys for Petitioner.

In a brochure put out by petitioner, the water system is described as follows:

In order to provide fire protection and to supply home owners in The Colony, with pure, soft water, The Colony will have its own private water works. The chief source is a well which is now producing 576,000 gallons of pure water each twenty-four hours, sufficient for the normal use of 14,000 people. Water will be supplied to home owners from a 75,000-gallon concrete reservoir. The water supply will at all times be under the supervision of the State and County Boards of Health.

The water system constructed by the petitioner was intended to supply 20 houses to be located near The Colony, as well as the houses located in The Colony subdivision. Also, during the taxable year ended October 31, 1948, the petitioner sold an additional 40 acres of land from the original farm tract. The 40 acres were sold at public auction, and in order to induce purchasers to pay a higher price, the petitioner agreed to provide water for the land.

The total cost incurred by petitioner in constructing the water supply system was $33,781.70, as follows:

Pumping system	$16,528.12
Distribution system	13,885.31
Engineering fees	2,864.18
Unclassified	504.09
Total	$33,781.70

The petitioner retained easements over lots which it sold in The Colony. These easements reserved to petitioner the right to maintain its water distribution system on the lots, but did not obligate petitioner to do so.

The water supply system began operation sometime during the taxable year ended October 31, 1949. Water meters installed by petitioner measured the water supplied to the houses served by the water distribution system, and petitioner was paid by the consumers for the

water it provided. In the taxable years ended October 31, 1949, to October 31, 1954, inclusive, petitioner realized, from the operation of its water supply system, the following amounts of gross receipts and profit or loss, the profit or loss being computed without deductions for electricity expense or depreciation:

Year ended October 31	Gross receipts	Net profit (or loss) before deduction for electricity or depreciation
1949	$211.89	($249.71)
1950	583.12	155.99
1951	258.08	(182.12)
1952	350.38	(382.39)
1953	421.37	(260.61)
1954	408.59	(183.96)

The largest item of expense incurred by the petitioner in the operation of the water system was for wages. L. J. Blakely, who lived near the pump site, was paid $300 per year to "look after" the water system in the years ending October 31, 1949, 1950, and 1951; $440 in the year ended October 31, 1952; $480 in the year ended October 31, 1953; and $400 in the year ended October 31, 1954.

The number of houses to which petitioner supplied water in each of the years set forth above is not shown in the record before us.

Throughout the taxable years and thereafter, the petitioner retained full ownership and control of the assets comprising the water supply system.

In 1948 and 1949, petitioner made payments to the Kentucky Utilities Company (hereinafter called Utilities Company) and the Central Kentucky Natural Gas Company (hereinafter called Gas Company), pursuant to agreements between petitioner and the companies relating to the

extension of gas and electricity service to The Colony. Petitioner's contract with the Gas Company was dated October 16, 1946. Petitioner entered into two contracts with the Utilities Company, one dated December 17, 1947, and the other dated December 1, 1949. The total payments made by petitioner to the two companies under the contracts amounted to $8,713.54, as follows:

Payee	Date of payment	Amount of payment
Gas Co.	January 6, 1948	$6,535.00
Utilities Co.	March 19, 1948	1,427.93
Utilities Co.	December 17, 1949	750.61
Total		$8,713.54

The payments made by petitioner were required by the companies before the latter would extend their services to The Colony. The contracts between petitioner and the companies provided that all or a part of the payments might be refunded to petitioner. For example, the contract with the Gas Company provided that the latter would refund to petitioner a total of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from date of the contract, that is, after October 16, 1956. Each of the contracts with the Utilities Company provided for the refund of approximately $160 to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions provided for in the contracts. Exhibits 16 and 17 are incorporated by this reference. Up to the date of the hearing of this proceeding, the petitioner had received refunds of $1,407.41 from the Utilities Company and $750 from the Gas Company, or a total of $2,157.41, as follows:

Date of refund	Refunds from Utilities Co.	Refunds from Gas Co.
Nov. 9, 1948	$ 162.27	$150
May 23, 1949	162.27	....
May 28, 1949	.....	150
1951	491.49	450
1954	591.38	....
Totals	$1,407.41	$750

An account titled "Reserve for Improvements" was set up on petitioner's books and credited on September 30, 1946, in the amount of $93,074.61. This amount represented petitioner's estimate of the costs which would be incurred in the development of The Colony, and petitioner added a pro rata portion of this amount to its cost of each of the lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950.

The reserve account was debited in the amount of each expenditure which petitioner considered an expense of development for the subdivision. As of September 30, 1950 the total amount debited to the reserve account was $87,483.79, and on that date there remained, from the original credit entry of $93,074.61, a credit balance of $5,590.82. The total amount debited to the reserve account, $87,483.79, consisted of the following entries: $33,781.70, the cost of the water supply system; $8,713.54, the total of the payments made to the utility companies; and $44,988.55 for other expenditures which are not in issue.

For the purpose of computing gain from the sale of the lots which were sold in 1946, 1947, and 1950, the petitioner added a proportionate part of $93,074.61, the amount originally credited to the reserve account for improvements to its cost of the lots sold. In its returns for the year ending October 31, 1946, 1947, and 1950, petitioner reported gain from the sale of lots and gross income, as follows:

	Year ended October 31		
	1946	1947	1950
Selling price of lots	$78,987.50	$28,075.00	$8,000.00
Less cost of lots sold	57,375.00	18,575.00	7,500.00
Gross profit on sale of lots	$21,612.50	$9,500.00	$500.00
Other income	637.53	8,595.41	8,909.25
Gross income reported	$22,250.03	$18,095.41	$9,409.25

The respondent determined that the development costs which might be added to petitioner's cost of the lots did not exceed $44,988.55. Accordingly, the respondent determined that petitioner had overstated its cost of the lots in the total amount of $48,086.06, which is the difference between the estimated development costs claimed by petitioner, $93,074.61, and $44,988.55, the amount determined by respondent. The respondent also determined that petitioner overstated the costs of lots sold and understated the profit from lot sales in the years ended October 31, 1946, 1947, and 1950, in the amounts of $20,972.54, $6,789.80, and $2,741.51, respectively. The amount of the adjustment in each of these years is the portion of the total overstatement of cost determined by respondent, $48,086.06, which is allocable to the lots sold in each year. The method used by respondent to redetermine petitioner's cost of the lots sold in each year is as follows: The petitioner claimed a basis of $131,550 in the entire subdivision, after adding in the amount of $93,074.61 for the estimated cost of improvements. The respondent determined that petitioner overstated its basis in the amount of $48,086.06, and that the petitioner's basis did not exceed $83,463.94. The basis determined by respondent, $83,463.94, amounted to 63.44655 per cent of the basis reported by petitioner. Accordingly, respondent allowed petitioner, as the cost of the lots it sold each year, an amount equal to 63.44655 per cent of the cost claimed by petitioner in its returns.

The deficiency notice contains the following explanation for respondent's determination that petitioner realized additional income in the amount of $20,972.54 from the sale of lots in the year ended October 31, 1946:

It is held that the cost of lots sold in the fiscal year ended October 31, 1946, reported in the return filed for that year as amounting to $57,375.00, is not in excess of the amount of $36,402.46, the reduction representing the allocable portion of the following items incorrectly included in the computation of the total cost of the lots in the subdivision (Sections 24(a) (2) and 43 of the Internal Revenue Code):

(a) Cost of water system	$33,781.70
(b) Deposits with utility companies	8,713.54
(c) Excessive provision, reserve for improvements	5,590.82
	$48,086.06

Similar explanations appear for the adjustments determined by respondent for the years ended October 31, 1947, and October 31, 1950.

The total amount of development costs includible in petitioner's basis in the subdivision lots is $53,702.09. This amount is the total of the development expenses incurred by petitioner which are not in issue $44,988.55, and the total of the payments made by petitioner to the utility companies, $8,713.54. The estimated development costs claimed by petitioner, $93,074.61, were overstated in the total amount of $39,372.52. The basis in the subdivision lots claimed by petitioner, $131,550, also was overstated in the total amount of $39,372.52. Petitioner's basis in the subdivision lots did not exceed $92,177.48, or 70.07 per cent of the basis it claimed.

Petitioner's basis for gain in the lots it sold in the years ended October 31, 1946, 1947, and 1950, did not exceed

70.07 per cent of the basis claimed in its returns for each of these years. Petitioner's basis in the lots sold in these 3 years was $40,202.66, $13,015.50, and $5,255.25, respectively, computed as follows:

Year ended October 31	Basis per return	70.07 per cent of basis reported in return
1946	$57,375	$40,202.66
1947	18,575	13,015.50
1950	7,500	5,255.25

Issue 3. Statute of Limitations.

In the taxable years ended October 31, 1946, and October 31, 1947, petitioner's gross income amounted to $39,422.37 and $23,654.91, respectively, computed as follows:

	Year ended October 31 1946	1947
Selling price of lots (per return)	$78,187.50	$28,075.00
Basis in lots	40,202.66	13,015.50
Profit from sale of lots	$38,784.84	$15,059.50
Other income (per return)	637.53	8,595.41
Total	$39,422.37	$23,654.91

In each of the years ended October 31, 1946, and October 31, 1947, petitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the amount of gross income stated in its returns. The following schedule sets forth, for the years ended October 31, 1946, and October 31, 1947, the amount of petitioner's gross income; the amount of gross income reported by petitioner; the amount of gross income omitted from petitioner's returns; and the percentage which the gross income omitted bears to the gross income reported:

	Year ended October 31	
	1946	1947
Gross income	$39,427.37	$23,654.91
Gross income reported	22,250.03	18,095.41
Gross income omitted	$17,172.34	$5,559.50
Gross income omitted as percentage of gross income reported	77.2 per cent	30.7 per cent

Petitioner's income and declared value excess-profits tax return for the taxable year ended October 31, 1946, was filed on January 15, 1947. More than 3 years and less than 5 years later, on October 17, 1951, petitioner executed an agreement under the provisions of section 276 (b) of the 1939 Code extending the period of limitations for the assessment and collectoin of deficiencies for the year ended October 31, 1946, to June 30, 1952. On May 14, 1952, petitioner executed a second agreement extending the period to June 30, 1953; and on April 25, 1953, petitioner executed a third agreement extending the period to June 30, 1954.

Petitioner's return for the taxable year ended October 31, 1947, was filed on December 22, 1947. More than 3 years and less than 5 years later, on May 14, 1952, petitoiner executed an agreement under the provisions of section 276 (b) of the Code extending the period of limitation to June 30, 1953. On April 25, 1953, petitioner executed a second agreement extending the period to June 30, 1954.

The respondent's statutory notice of deficiency for the years ended October 31, 1946, and October 31, 1947, was mailed on March 29, 1954.

OPINION.

Issue 1.

HARRON, *Judge:*

The first question to be decided is whether the payments made by petitioner to five of its stockholders in the amounts of $8,988.41, $3,468, and $3,468, in the taxable years ended October 31, 1948, 1949, and 1950, respectively, were payments of interest on indebtedness, which are deductible under section 23 (b) of the 1939 Code, or whether the payments constituted nondeductible distributions in the nature of dividends. The determination of this issue depends on whether the $57,800 paid by the shareholders to petitioner in return for petitioner's notes constituted, in substance, a loan giving rise to a creditor-debtor relationship, or a contribution to capital, which gave the stockholders an additional proprietary interest.

The petitioner concedes that it is a "thin corporation." It argues, however, that the notes must be recognized as a valid indebtedness because the petitioner's capitalization reflected the business judgment of unrelated persons who dealt with each other at arm's length; because the notes were issued to the stockholders in face amounts which were disproportionate to their stock holdings; and because the transaction was carried out in the form proper to create an indebtedness, rather than a contribution to capital. The respondent takes the position that the $57,800 paid in by the shareholders must be considered as a contribution on their part to petitioner's capital, in view of the capital structure of the petitioner, the circumstances under which the notes were issued, and the lack of evidence indicating that the transaction was intended to create a debtor-creditor relationship.

The question to be decided is one of fact. Sam Schnitzer, 13 T. C. 43, 60, affd. 183 F. 2d 70, certiorari denied 340 U. S. 911. The issue is whether there was an intention to create a debtor-creditor relationship, on the one hand, or a capital contribution, on the other hand, "and such intention is a fact to be gleaned from the entire record." Estate of Herbert B. Miller, 24 T. C. 923. It is true, in this case, that the notes received by the five shareholders upon their payment of $57,800 to petitioner satisfy the formal requirements for a corporate indebtedness. However, our inquiry is not limited to the formalities, however meticulously observed, in which the parties cast their transaction. R. M. Gunn, 25 T. C. —— (Dec. 9, 1955); Estate of Herbert B. Miller, supra; Gooding Amusement Co., 23 T. C. 408, 418; Proctor Shop, Inc., 30 B. T. A. 721, affd. 82 F. 2d 792. There are other factors present which establish that the $57,800 was paid over to petitioner by the stockholders to be placed immediately at the risk of petitioner's business as a capital contribution rather than as a true loan.

In the first place, the petitioner's formal capital, $1,000 was patently inadequate to carry on the business for which it was formed. The petitioner was organized to purchase, subdivide, and sell a substantial tract of land. For this purpose, petitioner's formal capital of $1,000 was wholly insignificant. To finance the project the additional amount of $57,800 was turned over to petitioner by the stockholders, and in addition the petitioner obtained loans of at least $149,403 from banks. The bank loans were secured by liens on petitioner's real estate. The notes received by the stockholders were not secured. If petitioner's characterization of the transaction is accepted, it is apparent that petitioner's business was placed in operation with loans in the amount of $207,203, and formal capital in the amount of $1,000. This alleged arrangement, which amounts to an indebtedness to capital ratio of greater than

207 to 1, clearly establishes that petitioner was undercapitalized and strongly suggests that the shareholders recognized that the $57,800 would be risked in petitioner's business as a capital contribution to the same extent as the formal capital of $1,000. See Hilbert L. Bair, 16 T. C. 90, affd. 199 F. 2d 589. In these circumstances, we think our language in Isidor Dobkin, 15 T. C. 31, 33, affd. 192 F. 2d 392, is particularly appropriate:

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business. Cohen v. Commissioner, 148 F. 2d 336; Joseph B. Thomas, 2 T. C. 193. The formal characterization as loans on the part of the controlling stockholders may be a relevant factor but it should not be permitted to obscure the true substance of the transaction. Sam Schnitzer, 13 T. C. 43, 60.

The conclusion that the parties did not regard the payment of the $57,800 to petitioner as a loan is also supported by their conduct subsequent to the issuance of the notes in April 1946. For example, the notes were not paid on the due date, namely, 5 years after issue, i. e., in April 1951. In fact, the evidence indicates that only one of the notes, that issued to L. B. Shouse, has been retired, and that the other notes were still outstanding at the time of the hearing of this proceeding. The stockholders other than Shouse held their notes as late as 1953, 2 years after the due date, and the evidence does not indicate that any attempt to enforce payment was ever made at any time after the due date. The parties treated their shares of stock and the notes as part of a single package whenever a transfer was made. For example, when petitioner acquired Shouse's note, it also acquired his stock. Similarly,

in the transaction in 1953, in which Sturgill and Central Rock Company acquired, in equal shares, the outstanding stock of petitioner held by Meriwether, Blakely, Leet, and Nunn, the notes held by the latter four persons also were acquired.

On the basis of the foregoing, it is concluded that the petitioner has failed to establish that the notes issued to its shareholders in the face amount of $57,800 represented a valid indebtedenss. It is held that the respondent properly disallowed the deductions claimed by petitioner for interest on indebtedness for the years ended October 31, 1948, 1949, and 1950, in the respective amounts of $8,988.41, $3,468, and $3,468.

In reaching our conclusion we have considered petitioner's contentions concerning the disproportionate holdings among the shareholders of stock and notes. Under the circumstances of this case, we attribute to this no greater weight than if petitioner had issued disproportionate amounts of common and preferred stock. Similarly, we consider of little weight petitioner's argument that the obligations represented by the notes were not subordinated to claims of other creditors. It is true that the notes, on their face, were not subordinate obligations. Under the facts of this case, however, little significance can be attached to this factor. For one thing, there was a lien on petitioner's principal asset, its real estate, in favor of the banks. This lien secured loans made by the banks to petitioner in the original amount of at least $149,403. In the second place, it appears that petitioner's liabilities in each of the taxable years were in negligible amounts, compared to the $57,800 in question. For example, petitioner's liabilities at the end of the taxable years October 31, 1946 to October 31, 1950, ranged from a low of $986.04 on October 31, 1949, to a high of $5,325.74 on October 31, 1946, and

averaged $2,470.29. On the entire record, it is concluded that the respondent must be sustained on this issue.

Issue 2.

The narrow question to be decided under this issue is the proper amount which petitioner may add to its cost of Colony lots for the cost of development work in The Colony subdivision. It is well established that where subdivision lots are sold before development work is completed, the seller may include in his cost of the lots an allocation of his estimated future expenditures for improvements to the subdivision. Country Club Estates, Inc., 22 T. C. 1283, 1293-1294; Cambria Development Co., 34 B. T. A. 1155.

The petitioner included in its cost of Colony subdivision lots a total of $93,074.12 for development expenses, and added a pro rata portion of this total to its cost of The Colony lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950. The respondent determined that the development expenses claimed by petitioner were excessive, and that the proper amount to be added to petitioner's cost of the lots did not exceed $44,988.55. The respondent accordingly reduced the cost or other basis which the petitioner claimed in the lots which were sold, and increased the profit reported by petitioner from the sale of these lots. The amount by which the respondent reduced the petitioner's cost or other basis in the lots in each of the years ended October 31, 1946, 1947, and 1950, equalled a pro rata part of $48,086.06, the total amount by which the respondent reduced the development costs claimed by petitioner. The petitioner does not contest the percentage method used by respondent to redetermine the cost of the lots, in the event it is determined that petitioner overstated its development costs. The petitioner does claim, however, that its development costs

were not overstated in the amount determined by the respondent.

The petitioner included in its cost of Colony subdivision lots a total of $93,074.12 for development expenses, and added a pro rata portion of this total to its cost of The Colony lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950. The respondent determined that the development expenses claimed by petitioner were excessive, and that the proper amount to be added to petitioner's cost of the lots did not exceed $44,988.55. The respondent accordingly reduced the cost or other basis which the petitioner claimed in the lots which were sold, and increased the profit reported by petitioner from the sale of these lots. The amount by which the respondent reduced the petitioner's cost or other basis in the lots in each of the years ended October 31, 1946, 1947, and 1950, equalled a pro rata part of $48,086.06, the total amount by which the respondent reduced the development costs claimed by petitioner. The petitioner does not contest the percentage method used by respondent to redetermine the cost of the lots in the event it is determined that petitioner overstated its development costs. The petitioner does claim, however, that its development costs were not overstated in the amount determined by the respondent.

The amount of estimated development costs disallowed by respondent, $48,086.06, is the total of three items, namely, an expenditure of $33,781.70 to construct a water supply system; payments to utility companies in the amount of $8,713.54; and the sum of $5,590.82, which is the excess of the petitioner's estimated development costs of $93,074.61 over the total amount it claimed to have expended for development purposes as of September 30, 1950, namely, $87,483.79. The respondent, in effect, allowed as development costs the total amount petitioner claimed to have expended as of September 30, 1950, other than the

cost of the water supply system and the amounts paid to utility companies.

The respondent's position under this issue is that the expenditures incurred to acquire the water supply system and to make payments to the utility companies are not properly chargeable to development costs which can be added to the cost of the subdivision lots. In the case of the portion of the estimated costs which petitioner had not expended as of September 30, 1950, or $5,590.82, the respondent contends that no part of the $5,590.82 will be required for future improvements, and that petitioner's original estimate of $93,074.61 for future developments was excessive in the amount of $5,590.82. The three adjustments will be discussed separately.

Petitioner introduced no evidence at the hearing of this proceeding to establish that further development work was required at The Colony after September 30, 1950, or that any expenditures were in fact made after that date for purposes of development or improvement. We accordingly sustain respondent's determination that the petitioner's estimate for future development costs, $93,074.61, was excessive in the amount of $5,590.82, which is the portion of petitioner's estimate which had not been expended as of September 30, 1950. Butler-Fornari Realty Corporation, 37 B. T. A. 933.

The next item under this issue relates to the water supply system. The petitioner has abandoned its original contention that the entire cost of the water supply system is a development expense which can be allocated to its cost of the subdivision lots. It concedes now that the "distribution system" or piping which carried the water from the "pumping system" to the houses, is not a development expense. It now claims that only the cost of the pumping station or pumping system is a development cost which should be added to its cost of the lots. The

petitioner contends that the lots were unsalable without a water supply system, and that it was required to construct such a system because the cost of connecting the subdivision with the facilities of the Lexington Water Company was prohibitive. The petitioner contends further that when the facilities of the Lexington Water Company eventually extend to the subdivision, the pumping station will be of no further use and will have no value other than for salvage. The petitioner contends that under these facts, the cost of the pumping system must be added to its cost of the lots. The petitioner relies on Country Club Estates, Inc., supra. In that case, the taxpayer was in the business of selling subdivision lots. In order to induce people to purchase lots, the taxpayer conveyed a portion of its tract to a nonprofit organization for the purpose of having a country club constructed. It was held that the cost of the property transferred by the taxpayer should be regarded as part of its basis in the subdivision lots which it sold.

The difficulty with petitioner's contention is that, unlike the taxpayer in Country Club Estates, Inc., supra, the petitioner has not given up any property in order to sell its lots. For the funds it expended, the petitioner acquired a water supply system which it owned and operated during the taxable years and thereafter. It is true that the system has not been operated at a profit, due, perhaps, to the small number of houses which have been constructed at The Colony. And it also may be true, as petitioner contends, that the pumping station may be abandoned at some time in the future, when the facilities of the Lexington Water Company reach the subdivision. These circumstances, however, do not alter the fact that the petitioner retained full ownership and control of the water supply system during the taxable years, and that it did not part with the property for the benefit of the subdivision lots.

Because of his retention of ownership, Country Club Estates, Inc., supra, is distinguishable. The retention of ownership also distinguishes this proceeding from cases in which the subdivider is permitted to add to his cost of lots the cost of land which has been dedicated or donated for use as streets. See, Commissioner v. Laguna Land & Water Co., 118 F. 2d 112, modifying, on other grounds, a Memorandum Opinion of the Board of Tax Appeals. We think the facts in this proceeding more closely resemble Biscayne Bay Islands Co., 23 B. T. A. 731. In the latter case, the taxpayer subdivided for sale the waterfront portion of its property. The interior portion of its property was set aside, for a term of years only, and not irrevocably, for use as a public park. It was held that the taxpayer's cost of the waterfront lots did not include the cost of the interior park property because the taxpayer had not irrevocably parted with the interior property. We said (page 735):

> This area was not permanently and irrevocably dedicated to the public, but may later be sold by petitioner. The possibility of gain has only been postponed. It is unlike the area used for public streets, which is permanently beyond the possibility of sale and gain, the cost of which must be absorbed in the salable lots. See *Oak Woods Cemetery Association*, 6 B. T. A. 1003.

It is held that the cost of the water supply system may not be added to the cost of The Colony subdivision lots for the purposes of computing petitioner's gain on the sale of such lots.

There is an additional dispute between the parties which relates to the cost of the water supply system. The respondent determined that the total cost of the system which the petitioner had added to its cost of the lots was $33,781.70. The petitioner claims that the cost of the system was $33,277.61, or $504.09 less than the amount determined by

respondent. The question is one of fact and the petitioner has the burden of proving the respondent's determination erroneous. The cost of the water supply system was not separately stated in the books of account maintained by petitioner. Petitioner relies, in support of its contention, on an analysis of invoices made by the engineer who supervised the construction of the water supply system. However, the evidence indicates that the engineer did not have available all the invoices relating to the construction of the system. At one point the engineer testified that "practically all" the bills for materials and services came into his hands; elsewhere, he stated that the bills of which he had knowledge accounted for about 80 per cent of the cost of the project. In either event, the petitioner has not established that the engineer upon whose testimony it relies had knowledge of the total cost of the system. It is concluded that the petitioner has failed to establish that the cost of the water supply system was less than the amount determined by the respondent. It is held that the cost of the water supply system was $33,781.70, and that this amount is not includible in the cost of The Colony lots sold by petitioner.

The final question relating to the petitioner's cost of The Colony lots concerns the payments made by petitioner to the Gas Company and to the Utilities Company. The petitioner made payments to the companies in the total amount of $8,713.54, and included this amount in the cost of its Colony lots. The respondent takes the position that the petitioner is not entitled to add any part of the payments to the cost of the lots it sold during the taxable years, because there existed a possibility that all or a part of the payments might be refunded to petitioner at some time after the taxable years.

The evidence establishes that the companies required the payments to be made before they would extend their

services to Colony. The payments were made to the companies in accordance with written agrements, the pertinent provisions of which are stated in the findings. Pursuant to the contract with the Gas Company, the petitioner paid $6,535 to the Gas Company in January 1948. The contract provided that the petitioner would receive a refund of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from the date of the contract, i. e., after October 16, 1956. In the case of the second company, the Utilities Company, the petitioner made payments in the total amount of $2,178.54 in 1948 and 1949. The contracts with the Utilities Company provided that a refund of approximately $160 would be paid to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions provided in the contract. The period during which petitioner was entitled to receive refunds from the Utilities Company did not expire during the taxable years.

It is true, therefore, as respondent contends, that there was no way to ascertain, during the taxable years, the total amount of refunds which petitioner might receive under its contracts with the two companies. We do not think, however, that this circumstance militates against the petitioner. The determinative factor is that the petitioner made unconditional payments to the two companies in order to obtain utility service for The Colony, and thereby to attract customers for The Colony lots. The payments were thus closely related to the sale of the lots, and petitioner's income from the sale of lots will be more clearly reflected if a pro rata portion of the payments in question are included in its basis for gain or loss in each lot which was sold. On the other hand, the receipt of refund pay-

ments from the utility companies is less closely related to the improvement of the lots for sale. The payment of a refund would be made only if a new customer was connected to the utility companies' service extensions, rather than at the time a lot was sold. Thus, if lots were sold to purchasers who, for some reason, did not proceed to construct residences, the petitioner would not receive refunds; or, if a purchaser acquired two or more lots, on which only one residence was constructed, the petitioner would receive only one refund, rather than a number of refund payments equal to the number of lots sold to the purchaser. Under these circumstances, it is concluded that the payments to the utility companies were directly related to the improvement of The Colony lots for sale, and that the petitioner correctly included these payments in computing its basis for gain or loss in the lots which it sold. The question of the taxability of the refunds which petitoiner may receive from the utility companies is not before us. It is noted, however, that the petitioner concedes, on brief, that such refunds would, if made, constitute taxable income. See Chevy Chase Land Co., 34 B. T. A. 150.

Issue 3.

The final question to be decided is whether the deficiencies determined for the taxable years ending October 31, 1946, and October 31, 1947, are barred by the statute of limitations. The deficiency notices for these 2 years were mailed within the extended period provided in waivers which the petitioner originally executed more than 3 years and less than 5 years after the returns were filed. The question is whether the 5-year statute of limitations con-

tained in section 275 (c) of the 1939 Code[1] is applicable in this proceeding. The petitioner omitted from gross income in each year an amount properly includible therein which was in excess of 25 per cent of the gross income reported. The petitioner contends, however, that section 275 (c) is inapplicable because the omission resulted from an overstatement of cost of goods sold, rather than from an omission of gross receipts. The petitioner relies on Uptegrove Lumber Co. v. Commissioner, 204 F. 2d 570, reversing a Memorandum Opinion of this Court; and on Deakman-Wells Co. v. Commissioner, 213 F. 2d 894, reversing 20 T. C. 610. Our holding in Estate of J. W. Gibbs, Sr., 21 T. C. 443, however, requires that this issue be decided in favor of the respondent. We have recently reviewed the decision in the Gibbs case in the light of the decisions in the Uptegrove Lumber Co. and Deakman-Wells Co. cases, and have decided to adhere to the rule in the Gibbs case. John E. Goodenow, 25 T. C. 1. On the basis of the Gibbs and Goodenow cases, it is held that the 5-year statute of limitations in section 275 (c) is applicable, and that the deficiencies determined for the years ending October 31, 1946, and October 31, 1947, are not barred by the statute of limitations.

Decision will be entered under Rule 50.

---

[1] SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

* * * * * * *

(c) OMISSION FROM GROSS INCOME.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1957.

No. 306.

THE COLONY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE PETITIONER.

S. L. GREENEBAUM,
B. H. BARNETT,
CHARLES F. WOOD,
A. ROBERT DOLL,
Attorneys for Petitioner.

GREENEBAUM, BARNETT & WOOD,
Kentucky Home Life Building,
Louisville, Kentucky.

RICHARD C. OLDHAM,
Kentucky Home Life Building,
Louisville, Kentucky.
Of Counsel.

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Where petitioner fully reported all of its gross receipts in its tax returns, but the Tax Court determined there had been an erroneous overstatement of cost of property sold, resulting in an error in the computation of gross income, such overstatement does not constitute an omission from gross income of any amount properly includible therein within the meaning of Section 275(c) of the Internal Revenue Code of 1939	10
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IN THE

Supreme Court of the United States

October Term, 1957.

No. 306.

THE COLONY, INC., - - - - - - *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE PETITIONER.

OPINIONS BELOW.

The opinion of the Court of Appeals is printed in the Record (R. 42). It is reported at 244 F. 2d 75. The opinion of the Tax Court of the United States is printed in the Record (R. 1). It is reported at 26 T. C. 30.

JURISDICTION.

The judgment of the Court of Appeals was entered on April 22, 1957 (R. 42). The petition for a writ of certiorari was filed on July 22, 1957, and was granted on October 14, 1957 (R. 43). The jurisdiction of this Court is invoked under 28 U. S. C. Sec. 1254 (1).

QUESTION PRESENTED.

The single important question presented by this case may be stated in two different ways:

1. Where petitioner reported all of its gross receipts on its federal income tax returns, is the five year statute of limitations provided by Section 275(c) of the Internal Revenue Code of 1939 nevertheless applicable because of an erroneous overstatement of the cost basis of the property sold in an amount in excess of 25% of the gross income computed and stated in the returns?

2. Does the language "omits from gross income an amount properly includible therein", as stated in Section 275(c) of the 1939 Code, mean (a) "leaves out an item or items of receipt from his computation of gross income", or (b) "understates the final figure in his gross income computation"?

STATUTE INVOLVED.

The full text of Section 275(c) of the Internal Revenue Code of 1939 (26 U. S. C. 1946 ed., Sec. 275(c)) is as follows:

"Sec. 275—Period of Limitation Upon Assessment and Collection.

* * * * * * *

"(c) *Omission From Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25%

of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

STATEMENT OF THE CASE.

The material facts are not in dispute. As found by the Tax Court (R. 3, 7-15), and contained in the Record, they may be summarized as follows:

Petitioner is a corporation organized under the laws of the Commonwealth of Kentucky on or about November 14, 1945 (R. 3). Petitioner kept its books and filed its federal tax returns on an accrual method for fiscal years ended October 31 (R. 3). Petitioner filed federal income tax returns for its taxable years ended October 31, 1946 and October 31, 1947 with the Collector of Internal Revenue for the district of Kentucky (R. 3).

Shortly after its organization, petitioner acquired a farm near Lexington, Kentucky (R. 7). Petitioner's principal business during 1946 and 1947 consisted of the subdivision and development of the farm land into residential lots, and the sale of such lots to individual buyers (R. 7, 8).

In its federal income tax returns for its taxable years ended October 31, 1946 and 1947, petitioner reported *all* of the gross receipts realized from the sale of lots during said years (Resp. Ex. D, Sch. A; R. 32 and Resp. Ex. E, Sch. A; R. 38). In said tax returns, petitioner subtracted the reported cost of the lots sold from the gross sales proceeds to compute the gross

profit on lot sales (Resp. Ex. D, Sch. A; R. 32 and Resp. Ex. E, Sch. A; R. 38). The resulting gross profit was then combined with petitioner's other income, and the total carried forward and shown on page 1 of each tax return at line 15, labeled "Total income" (Resp. Ex. D; R. 27 and Resp. Ex. E; R. 36).

Petitioner's reported cost basis of the lots sold included a proportionate part of the estimated cost of developing the subdivision (R. 8). A principal item included therein was the expense of constructing a water supply system (R. 8).

Upon examination of petitioner's federal income tax returns for its taxable years 1946 to 1950, inclusive, respondent disallowed apprpximately one-half of the total estimated development costs, including the cost of the water supply system (R. 8). As a result of his determination, respondent reduced the cost of the lots sold as claimed in the tax returns for the taxable years 1946 and 1947, thereby increasing petitioner's gross profit from the sale of lots, and "Total income" (or "gross income"[1]) for said years by the same amount.

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[1]There is no single item or line on the corporate income tax return (Treasury Form 1120) labeled "gross income". However, the heading to the first 15 lines of the return is "Gross Income", and line 15 is labeled "Total income". The figure to be inserted on line 15 is reached as a result of computation—*e. g.*, gross receipts, less cost of goods sold, plus other income is equal to "Total income". Thus, "Total income" on the tax return is synonymous with "gross income of a manufacturing, etc, concern" as defined by Treasury Regulations 111, Sec. 29.22(a)-5.

In this brief, petitioner, solely for purposes of convenience, uses the terms "Total income" and "gross income" interchangeably. Petitioner does not concede that, as a matter of law, "Total income" and "gross income of a manufacturing etc. concern" are synonymous or interchangeable.

Respondent's statutory notice of deficiency for the years ended October 31, 1946 and October 31, 1947 was mailed to the petitioner within an extended period provided in waivers which petitioner executed more than three years but less than five years after the returns for said taxable years were filed (R. 15).

Petitioner duly and timely filed a petition with the Tax Court of the United States. The Tax Court held that the respondent was correct in disallowing certain of the claimed development costs, including the cost of the water supply system, thereby increasing gross income by the same amount (R. 19-25). The Tax Court held that, as a result of the overstatement by petitioner on its tax returns for the years 1946 and 1947 of the cost of the lots sold, petitioner "omitted" from gross income an amount properly includible therein which was in excess of 25% of the amount of gross income stated in its returns (R. 15). Accordingly, the Tax Court ruled that the five year period of limitations contained in Section 275(c) of the Internal Revenue Code of 1939 was applicable, and that the assessment of the deficiencies for the years 1946 and 1947 was not barred (R. 25).

Petitioner duly and timely appealed to the Court of Appeals for the Sixth Circuit on the sole question of whether the five year statute of limitations was applicable in respect of the deficiencies determined for the taxable years ended October 31, 1946 and October 31, 1947. The Court of Appeals affirmed the Tax Court, stating in its opinion as follows (R. 42, 43):

". . . it is the petitioner's contention that the general three year limitation period of section 275(a) of the 1939 Code is applicable. As petitioner's counsel correctly points out, the decisions of the Courts of Appeals of several other circuits give clear support to this view. *Uptegrove Lumber Co.* v. *Commissioner,* 204 F. 2d 570 (3 Cir., 1953); *Deakman-Wells Co.* v. *Commissioner,* 213 F. 2d 894 (3 Cir., 1954); *Goodenow* v. *Commissioner,* 238 F. 2d 20 (8 Cir., 1956) cf. *Slaff* v. *Commissioner,* 220 F. 2d 65 (9 Cir., 1955); *Davis* v. *Hightower,* 230 F. 2d 549 (5 Cir., 1956).

"The reasoning of these cases is not without considerable persuasive force, and if the question were here for the first time, we might be disposed to follow them. However, the question has already been decided by this court in *Reis* v. *Commissioner,* 142 F. 2d 900 (6 Cir., 1944), where it was held that the five-year limitation was applicable when the taxpayer's understatement of gross income of more than twenty-five per cent was the result of his overstatement of the cost basis of property sold. The facts in the *Reis* case are, of course, not identical with the facts in the present case, but the issue presented is the same.

"Upon the authority of *Reis* v. *Commissioner* the decision of The Tax Court is affirmed."

SUMMARY OF ARGUMENT.

Section 275(a) of the Internal Revenue Code of 1939 provides that income taxes generally must be assessed by the Commissioner of Internal Revenue within three years after the tax return is filed.[2] Section 275(c), an exception to the general rule, provides that the Commissioner has two additional years (five years after the return is filed) to assess the tax if the taxpayer "omits from gross income" an amount in excess of 25 per centum of the gross income reported in the return.

Section 275(c) is not applicable where a taxpayer (such as petitioner) fully reports all gross receipts in his tax return, but erroneously overstates the cost basis of the property sold, thereby reducing gross profit from sales, and gross income, by the same amount. The statute is applicable only where a taxpayer leaves out items of receipt in the statutory amount from the computation of gross income.

A. The key-word in the statute is the verb "omits". In normal usage, omits means "to leave out or unmentioned; not to insert, include or name".

B. The legislative history shows beyond question that Congress enacted Section 275(c) for the sole purpose of giving the Commissioner a period longer than

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[2] "Sec. 275. *Period of Limitation Upon Assessment and Collection.* (26 U. S. C 1946 ed., Sec. 275)

Except as provided in section 276—

(a) *General Rule*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."

three years to discover income in the case of taxpayers who failed to fully report their receipts. The relevant Congressional Committee reports and discussions at committee hearings point specifically and only to the taxpayer, who, to use the Committees' words, "failed to disclose", who was "so negligent as to leave out items of such magnitude", who "left out", who "was so negligent and so forgetful, or whatever the reason is, that he overlooks an item amounting to as much as 25%", who "failed to report".

C. From a logical standpoint, the statute can be applicable only to situations where a taxpayer left out items of receipts in his computation of gross income.

Overstatements of cost of goods sold are similar in nature to other expenditures expressly deductible by statutory law. Both are *subtrahend* items, and for benefit to be derived therefrom, both must be specifically claimed in the tax return. The Commissioner is immediately put on notice of the items by a mere examination of a tax return, and is given ample opportunity to investigate.

It is clear that the Commissioner must challenge claimed statutory deductions within the normal three year limitation period. It is not logical to assume that Congress would wish to allow a longer time to challenge increased income resulting from overstatements of *subtrahends* in the gross income section of a return.

D. Four Circuit Courts of Appeal have held uniformly in varying factual situations that the verb "omits" as used in Section 275(c) means "leaves out"

some item of receipt from the computation of gross income. Each court has rejected the Commissioner's contention that the statute can be applied where a taxpayer understates the final figure in his gross income computation. The court below stands alone among the federal appellate courts in construing the statute to apply to mathematical understatements of gross income resulting solely from an overstatement of the cost of goods sold.

E. Section 6501 (e)(1)(A) of the Internal Revenue Code of 1954,[3] the successor to Section 275(c), expressly spells out the construction of Section 275(c) urged herein. The old language of Section 275(c) was re-enacted, and the new langugae was added to clarify the law under the 1939 Code.

The statutory language, the legislative history, logical reasoning, the weight of judicial authority in the courts below, and the enactment by Congress of Section 6501(e)(1)(A) of the Internal Revenue Code of 1954 establish that "omits from gross income" as used in Section 275(c) means leaving out items of receipts in the computation of gross income. An *overstatement* of the cost of property sold, resulting in an *error* in the computation of gross income, does not entitle the Commissioner to the benefit of the extended period of limitations provided for by the statute.

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[3]Quoted, note 9, at page 23, *infra*.

ARGUMENT.

Where petitioner fully reported all of its gross receipts in its tax returns, but the Tax Court determined there had been an erroneous overstatement of cost of property sold, resulting in an error in the computation of gross income, such overstatement does not constitute an *omission* from gross income of any amount properly includible therein within the meaning of Section 275(c) of the Internal Revenue Code of 1939.

Petitioner fully reported all of its gross receipts on its tax returns for its taxable years ended October 31, 1946 and October 31, 1947. However, petitioner, in good faith, but erroneously, overstated the cost of the property sold in said tax returns.[4] In subtracting the erroneously overstated cost of the property sold from the correctly stated gross receipts, the error in the *subtrahend* was carried forward, thereby reducing petitioner's reported gross profit on sales and gross income in an amount equal to the erroneous overstatement of the cost of the property sold.

Respondent's statutory notice of deficiency was mailed after the expiration of the general three year statute of limitations provided for by Section 275(a) of the Internal Revenue Code of 1939. The ultimate issue in the case is whether the extended five year

[4]The principal item of overstatement consisted of the cost of constructing a water supply system in the amount of $33,781.70. In ruling against petitioner on this item, the Tax Court recognized the legal issue involved and was compelled to distinguish the case of *Country Club Estates, Inc.* (1954), 22 T. C. 1283, 1293-1294. Thus, petitioner's original computation of cost reported on its tax returns had a reasonable basis, and *there is no suggestion of fraud, negligence or lack of good faith* in this case.

period of limitations contained in Section 275(c) of the Internal Revenue Code of 1939 is applicable. Section 275(c) reads as follows:

> "Sec. 275—Period of Limitation Upon Assessment and Collection.
>
> * * * * * * * *
>
> "(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25% of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within five years after the return was filed."

Petitioner contends that it did not "omit(s) from gross income an amount properly includible therein" within the meaning of Section 275(c) by reason of the erroneous overstatement of the cost of the property sold. Petitioner asserts that the word "omits" in the statute means what it says; and a taxpayer "omits" an amount from gross income within the meaning of Section 275(c) *only when he leaves some item of receipt out of his computation of gross income.*

On the other hand, respondent contends "that where, as in the case at bar, a taxpayer overstates basis by more than 25% in reporting gains from the sale of property, the result is an understatement of gross income by more than 25%, and the requirements of 275(c) are met."[5] Thus respondent would have this

[5]Memorandum for the Respondent, page 4, in response to the petition for a writ of certiorari.

Court construe the statutory language "omits from gross income any amount properly includible therein" as if it read "understates the final figure in his gross income computation".

The issue in this case is therefore reduced to the narrow question of the proper statutory construction to be given to the statutory language "omits from gross income any amount properly includible therein". For the reasons hereinafter stated, petitioner asserts that the extended period of limitations can not be invoked by the Commissioner unless a taxpayer *leaves out* some item of receipt from his computation of gross income.

A. The Statutory Language.

The heading of Subsection (c) of Section 275 is entitled "*Omission From Gross Income.*"

The key word in the statute is the verb "omits". Congress could have chosen another verb such as "reduces", or "understates", both of which verbs have broader meaning. It did not choose these words, but selected "omits".

"Omit" has a definite and restricted meaning. *Webster's New International Dictionary*, 2d ed. (1939), defines "omit" as "to leave out or unmentioned; not to insert, include or name".

The Court of Appeals for the Sixth Circuit has similarly defined "omits" as meaning "to disregard, to fail, forbear, neglect to mention or fail to insert or include". *Ewald v. Commissioner* (C. A. 6th, 1944), 141 F. 2d 750, 752.

If the verb "omits" is given its normal and usual meaning, its use in the statute *is limited* to situations of the *leaving out* of specific items of receipt or gain that should properly be included in a taxpayer's computation of gross income.

As this Court stated in *DeGanay* v. *Lederer* (1919), 250 U. S. 376, 381, "Unless the contrary appears, statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

The clearest and strongest expression of congressional intent would have to be found in the legislative history before a holding could be justified that an overstated *subtrahend* is, or results in, an *omission*.

B. The Legislative History of Section 275(c).

The legislative history of the section shows that Congress carefully and deliberately selected the verb "omits", and intended for the usual meaning to be ascribed to it.

Section 275(c) was created by Congress as an exception to the long standing general three years period of limitation on assessment. The provision first appeared as Section 275(c) of the Revenue Act of 1934, c. 277, 48 Stat. 680. The bill, originating in the House, changed Section 276 of the Revenue Act of 1932, c. 209, 47 Stat. 169, relating to false or no returns, and carried no period of limitations. The intended coverage of the proposed provision was stated in a subcommittee report published as part of the House Hearings before the

Committee on Ways and Means, 73d Cong., 2d Sess., Revenue Revision of 1934, p. 139, as follows:

> "Section 276 provides for the assessment of tax without regard to the statute of limitations in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax.
>
> "Your subcommittee is of the opinion that the limitation period on assessment should also not apply to certain cases where the taxpayer has understated his gross income on his return by a large amount, even though fraud with intent to evade tax cannot be established. It is, therefore, recommended that the statute of limitations shall not apply where the taxpayer *has failed to disclose in his return* an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized where a taxpayer is so negligent as to *leave out items* of such magnitude from his return." (Emphasis added.)

The subcommittee conceived of the proposed section as a parallel to the unlimited period for assessment with respect to taxpayers filing no returns, or fraudulent returns, and therefore recommended no period of limitation on assessment. Obviously, the subcommittee intended the proposed provision to apply only to situations tantamount to filing no return, or a fraudulent return, such as where a taxpayer "has failed to disclose in his return", or "leave(s) out" substantial items of income.

Curiously, the Treasury Department, represented by Roswell Magill, expressed opposition to the bill be-

cause it felt that three years was time enough for the Government "to find out about these things, and it is desirable at some time for a taxpayer to be able to know that his liability is closed in the absence of fraud" (Id. at p. 149).

At hearings held before the full Committee, the following colloquy ensued between the late Congressman Jere Cooper of Tennessee, speaking for the subcommittee, and Mr. Magill (Id p. 149):

> "Cooper: What we really had in mind was just this kind of a situation: Assume that a taxpayer left out, say, a million dollars; he just forgot it. We felt that whenever we found that he did that we ought to get the money on it, the tax on it.
>
> Magill: I will not argue against you on that score.
>
> Cooper: In other words, if a man is so negligent and so forgetful, or whatever the reason is, that he overlooks an item amounting to as much as 25 percent of his gross income, that we simply ought to have the opportunity of getting the tax on that amount of money.
>
> Magill: Yes; so far as the cases you have mentioned are concerned, we would certainly agree with you. Now, the fellow we were thinking of—and maybe we thought of him too much—i. the individual who had honestly tried to include all he thought he should have, but he did not."

The full Committee adopted the bill of its subcommittee. The report of the Committee, published in H. Rep. No. 704, 73d Cong., 2d Sess., p. 35 (1939-1 Cum. Bull. (Part 2) 554, 580), states in part as follows:

> ". . . It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute."

The Senate Finance Committee approved of the intended coverage and language of the bill, except that it felt that the absence of a cut-off period was not justified, stating in part in its report as follows:

> ". . . Your committee is in general accord with the policy expressed in this section of the House bill. However, it is believed that in the case of a taxpayer who makes an honest mistake, it would be unfair to keep the statute open indefinitely. For instance, a case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital or he might report as income for one year an item of income which properly belonged in another year. Accordingly, your committee has provided for a 5-year statute in such cases." Senate Finance Committee Report, S. Rep. No. 588, 73d Cong., 2d Sess. pp. 43-44.

In the face of the clear statements of Congressional intent, respondent, on occasion, has stressed the infrequent use of the phrase "understates gross income" in the relevant Committee reports. Respondent ignores the fact that wherever this language appears, it is used in a general introductory statement. Immediately following each such reference is a specific restrictive statement or illustration of a "failure to disclose" income or "leaving out" items of receipt. See *Uptegrove*

Lumber Co. v. *Commissioner* (C. A. 3d, 1953), 204 F. 2d 570, 572.

It is impossible to review the legislative history of Section 275(c) without becoming convinced that it was designed only to give the Commissioner a period longer than three years to discover income in the case of taxpayers who had failed to fully report their receipts. All the discussion, all indicia of intent, point specifically and only to the taxpayer, who, to use the Committee's words, "failed to disclose", who was "so negligent as to *leave out* items of such magnitude", who "left out", who "was so negligent and so forgetful, or whatever the reason is, that he *overlooks* an item amounting to as much as 25%", who "failed to report". Nowhere in the legislative history can there be found indications that Congress intended for the extended statute to apply to situations such as in the case at bar.

C. Logic.

It was reasonable and logical for Congress to grant the Commissioner an additional two year period to assess deficiencies in respect of receipts omitted from a tax return. It was not that overstated costs, or inflated deductions were condoned, but merely that the latter did not present as substantial problems of discovery for the Internal Revenue Agents on audit. For benefit to be taken of an expenditure, it must be specifically claimed in the tax return, and the agent is *immediately put on notice by a mere examination of the return*, and should have ample opportunity to in-

vestigate. On the other hand, an omitted receipt requires a more complex process of detection. Congress gave the Commissioner two additional years to act in the last situation.

It is illogical to assume that Congress intended for an overstatement of cost of goods sold, resulting in a reduced gross income, to constitute an omission within the meaning of the statute. Expenditures forming a part of cost of goods sold are not different in nature from the deductible expenditures permitted by law.[6] In the latter case, it is clear that the Commissioner must challenge the claimed deductions within the normal three year limitation period. No reason appears why Congress would wish to allow a longer time to discover overstatements of the same type in the gross income section of the return. *Uptegrove Lumber Co.* v. *Commissioner, supra.* Consistency dictates otherwise.

Finally, it is general knowledge that a great number of all tax returns filed are returns for non-business individuals. In a majority of cases, gross receipts and gross income are synonymous. Obviously, the statute was intended for the sole purpose of extending the normal statutory period of limitations in cases where items of receipt were left out of a return.

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[6]Sec. 23 of the Internal Revenue Code of 1939 (26 U. S. C. 1946 ed., Sec. 23) provides that numerous business expenditures may be deducted (or subtracted) from "gross income" to arrive at "net" or "taxable" income upon which the tax is imposed. As previously mentioned, cost expenditures are also *subtrahend* items, and are subtracted (or deducted) from gross receipts to arrive at "Total income" or "gross income". Note 1, at page 4, *supra*.

D. The Cases in the Courts of Appeal.

The majority of the courts below have adopted the construction of the statute urged herein by the petitioner.

Frequently cited is *Uptegrove Lumber Co.* v. *Commissioner* (C. A. 3d, 1953), 204 F 2d 570 The facts therein can not possibly be distinguished materially from the facts in the instant case. In an opinion by Circuit Judge Hastie, the Court of Appeals for the Third Circuit meticulously reduced the issue to its essence, traced the legislative history of Section 275(c), pointed up the logical considerations, rejected the arguments of the Commissioner, and concluded that Section 275(c) could apply only where a taxpayer failed "to include some receipt or accrual in his computation of gross income".

Several months after its decision in *Uptegrove Lumber Co., supra,* the Court of Appeals for the Third Circuit was again called upon to interpret Section 275(c) in *Deakman-Wells Co.* v. *Commissioner* (C. A. 3d, 1954), 213 F. 2d 894. There, the taxpayer corporation kept its books of account on the accrual basis but filed its income tax returns on the cash basis. On the tax return, all gross receipts computed on the accrual basis were shown on a schedule attached to the return, and accounts receivable and accounts payable were added and subtracted therefrom in order to arrive at gross income computed on the cash basis.

The Court reaffirmed its reasoning and decision in the *Uptegrove* case, stating as follows, at page 897:

> ". . . We recently had occasion to consider the scope of that subsection in Uptegrove Lumber Co. v. Commissioner of Internal Revenue, 3, Cir., 1953, 204 F. 2d 570. *In that case we pointed out that the statute applies only where the taxpayer has failed to make a return of some taxable gain, where he has altogether omitted an item from the income reported, and not to a case such as this where he merely understates the final figure in his gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure.* We adhere to the views which we expressed in the Uptegrove case and conclude that the Tax Court erred in holding section 275(c) applicable." (Emphasis added.)

On March 4, 1955, the Court of Appeals for the Ninth Circuit held that the extended statute of limitations provided by Section 275(c) was inapplicable where a taxpayer made full disclosure of all receipts on his return. *Slaff* v. *Commissioner* (C. A. 9th, 1955), 220 F. 2d 65. In upholding the contentions of the taxpayer, the Court of Appeals for the Ninth Circuit stated that it was in full accord with the rulings of the Court of Appeals for the Third Circuit in *Uptegrove Lumber Co., supra,* and *Deakman-Wells Co., supra.*

The next pertinent decision by a Court of Appeals was handed down on February 29, 1956, by the Fifth Circuit in the case of *Davis* v. *Hightower* (C. A. 5th,

1956), 230 F. 2d 549. Therein the taxpayer treated profits from the sale of cotton as capital gains, and only 50% of the profits were included in the computation of gross income on the face of the return. In deciding that Section 275(c) was inapplicable, the Court adopted the interpretation thereof enunciated by the Court of Appeals for the Third Circuit in the *Uptegrove* and *Deakman-Wells'* cases, and approved by the Court of Appeals for the Ninth Circuit in the *Slaff* case.

In the latter part of 1956, the Court of Appeals for the Eighth Circuit expressly approved as "sound" and "logical" the aforesaid decisions of the Court of Appeals of the Third Circuit. *Goodenow* v. *Commissioner* (C. A. 8th, 1956), 238 F. 2d 20.[7]

Four Circuit Courts of Appeal, therefore, have uniformly held in varying factual situations that the verb "omits" as used in Section 275(c) means "leaves out" some item of receipt from the computation of gross income. Each court has *rejected* the plea that the statute be extended to read "If the taxpayer *understates the final figure* in his gross income computation". It is respectfully submitted that the opinions of the Courts of Appeal for the Third, Ninth, Fifth and Eighth Circuits, and of the Court of Claims, warrant careful consideration by this Court.

The decision of the court below in the instant case, and in *Reis* v. *Commissioner* (C. A. 6th, 1944), 142 F. 2d 900, is in direct conflict with the above cited deci-

[7] *Cf. Lazarus* v. *United States* (Ct. Cls., 1956), 142 F. Supp. 897.

sions In the appellate courts, the decisions of the Court of Appeals for the Sixth Circuit stand alone.[8]

The opinion of the court below in the instant case suggests misgivings. After referring to the above cited cases decided by the Courts of Appeal for the Third, Ninth, Eighth and Fifth Circuits, the court stated as follows (R. 42):

> "The reasoning of these cases is not without considerable persuasive force and if the question were here for the first time we might be disposed to follow them. However, the question has already been decided by the Court in *Reis* v. *Commissioner*, . . ."

The conflicting decisions of the Court of Appeals for the Sixth Circuit appear to be a judicial accident. In *Ewald* v. *Commissioner* (C. A. 6th), 141 F. 2d 750, where the taxpayer *left out* a substantial amount of trust income properly includible in his computation of gross income, the court correctly found an *omission* from gross income within the meaning of Section 275(c). Subsequently, in the *Reis* case, *supra*, which involved an overstatement of cost of goods sold, the court, apparently without careful analysis, erroneously found an omission, *citing the Ewald case as authority*. The mistake was compounded in the instant case.

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[8]The decisions of the Tax Court of the United States are in accord with the position taken by the Court of Appeals of the Sixth Circuit. However, after the appellate court decisions in *Uptegrove Lumber Co., supra, Deakman-Wells, supra*, and *Slaff* v. *Commissioner, supra*, four of the twelve Judges of the Tax Court adopted the principles and reasoning expressed therein. See *Goodenow* v. *Commissioner* (1955), 25 T. C. 1, 4 (dissenting).

The *Ewald* decision is correct. The decisions in *Reis* and in the instant case, where the facts were totally different, are erroneous. The statutory language, legislative history, logic and the weight of judicial authority incontrovertibly establish that Section 275(c) can not justifiably be extended to embrace mathematical understatements resulting solely from overstated *subtrahends*.

E. Section 6501(e)(1)(A) of the Internal Revenue Code of 1954.

The conflicting interpretations of Section 275(c) enunciated in the *Uptegrove Lumber Co.* case, *supra*, on the one hand, and the *Reis* case, *supra*, and numerous decisions of the Tax Court, on the other hand, were well known prior to the enactment of the Internal Revenue Code of 1954.

In 1954, Congress enacted Section 6501(e)(1)(A) of the 1954 Code[9] as the successor provision to Sec-

---

[9] "(e) *Omission From Gross Income.*—Except as otherwise provided in subsection (c)—

(1) *Income Taxes.*—In the case of any tax imposed by subtitle A—

(A) *General Rule.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term 'gross income' means the total of the amounts received or accured from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(Footnote continued on following page)

tion 275(c) of the 1939 Code. The same language "omits from gross income an amount properly includible therein" was re-enacted, and, by way of addendum, subsection (i) was inserted. Subsection (i) expressly spells out the construction of Section 275(c) contended for by petitioner.

Congress must have enacted the new language of the 1954 Code to clarify existing law. The Court of Appeals for the Fifth Circuit in *Davis v. Hightower, supra*, has so held, stating at page 554 as follows:

> "The two cases decided by the Court of Appeals for the Third Circuit recognize that either construction could be placed on this statute (Section 275(c)) and largely on the basis of the legislative history, it makes the test the question whether a specific item of income has been completely omitted from the return.[6] To this legislative history is now added the amendment contained in the 1954 Internal Revenue Code, under the terms of which it is now clear that the inclusion of the statement made by appellee in his return here would be sufficient to prevent application of the five year statute.[7] *In view of the confusion as to the meaning of the statute prior to the adoption of the 1954 Code, we think it plain that the new language was enacted to clarify the existing law.*" (Emphasis added.) (Footnotes 6 and 7 omitted.)

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item."

CONCLUSION.

The statutory language of Section 275(c), its legislative history, logical reasoning, the weight of judicial authority in the courts below, and the enactment by Congress of Section 6501(e)(1)(A) of the Internal Revenue Code of 1954 establish:

(1) "Omits from gross income any amount properly includible therein", as used in Section 275(c) of the 1939 Code, means leaving out items of receipt in the computation of gross income;

(2) An overstatement of the cost of property sold, resulting in an error in the computation of gross income, does not constitute an omission from gross income of any amount properly includible therein, within the meaning of the statute.

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals for the Sixth Circuit must be reversed.

S. L. GREENEBAUM,
B. H. BARNETT,
CHARLES F. WOOD,
A. ROBERT DOLL,
Attorneys for Petitioner.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1957

No. 306.

THE COLONY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY BRIEF FOR PETITIONER.

S. L. GREENEBAUM,
B. H. BARNETT,
CHARLES F. WOOD,
A. ROBERT DOLL,
Attorneys for Petitioner.

WEBSTERFIELD-BONTE CO., INCORPORATED, LOUISVILLE, KY.

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IN THE

Supreme Court of the United States

October Term, 1957

No. 306.

THE COLONY, INC., - - - - - - *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY BRIEF FOR THE PETITIONER.

Respondent argues that Section 275(c) of the 1939 Code is applicable in any and all cases where a taxpayer's reported gross income is understated by more than 25%. Thus, respondent would construe the statute as if it read "If the taxpayer understates the final figure in his gross income computation".

The reasons advanced by the respondent in support of his conclusion are without substance, and the conclusion reached is therefore without merit.

A. *Preliminary* (Resp. Br., pp. 11-15).

In this section of his brief, respondent argues—

(1) That Congress, in enacting Section 275(c), decided to provide for a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large; and

(2) There is, accordingly, an essential correlation between its description of that error and its expression of the standard for measuring it; and,

(3) It would seem logically to follow that a taxpayer has omitted from gross income an amount properly includible therein when he has understated that amount.

The first premise in the respondent's syllogism is patently fallacious.

For one reason or another, taxpayers make (and always have made) large errors in that they overstate the amount of the deductions authorized by Section 23 of the 1939 Code. For example, many taxpayers have overstated wage deductions (such as overceiling salary payments); traveling expenses (such as a trip to Europe for part business and part personal purposes); rental payments (which, as a matter of law, are purchase price payments under conditional sales contracts); interest (thin corporation cases); and taxes, business losses, bad debts, etc. Unquestionably, the extended period of limitations of the statute may not be invoked in cases of overstated expenditures claimed as deductions from gross income, *regardless of the size of the overstatement.*

Respondent disclaims knowledge as to the reason why Congress failed to draft the statute in such language as to fully carry out the intent attributed to it by respondent (Resp. Br. 12).

Petitioner submits an answer—Congress did not, in fact, intend for Section 275(c) to provide for a longer period for assessing deficiencies because of the presence of *any* relatively large error in a tax return adversely affecting the revenue. Congress intended for the statute to apply solely to cases where a taxpayer "omits" items of receipt from his computation of gross income. To use the words of the congressional committees, the statute is only applicable where a taxpayer "leave(s) out" items, "left out", "overlooks", "fail(s) to report".

The statute is not applicable in the case of errors in the form of overstated deductions. Similarly, Congress was not concerned with errors in the form of overstated cost items in the gross income section of a return. Both are "offset" items, identical in nature, and for benefit to be derived therefrom in a tax return, both must be claimed in the return. The Internal Revenue Service is not faced with the same serious discovery problems that are present where a taxpayer "omits" items of receipt properly includible in his computation of gross income.

On the basis of its faulty major premise, respondent apparently attempts to spell out "an essential correlation between its (Congress') description of that error and its expression of the standard for measuring it." To impute to Congress such a complicated intent or

objective is to indict Congress for drafting a completely inadequate statute. Obviously Congress was not thinking in terms of elusive "correlation(s)".

Respondent's reasoning is unsound, and accordingly, his conclusion is equally unsound.

B. *The Statute and its Legislative History* (Resp. Br., pp. 15-24).

Respondent emphasizes and re-emphasizes the term "gross income", but adroitly avoids direct discussion of the verb "omits".

Respondent begins his argument by referring to Section 22(a) of the 1939 Code, which defines gross income in general as including, ". . . gains or profits and income derived from any source whatever . . ." Respondent proceeds to Section 111(a) of the 1939 Code which provides, in effect, that in computing the gain or loss from the sale or other disposition of property, the "gain" from a sale is the difference between the total sales proceeds and the cost of the property sold. Therefore, concludes respondent, only "gains" from the sale of property are properly includible in gross income, and accordingly, all understatements of "gains" are automatically omissions from gross income within the meaning of Section 275(c).

Respondent finally reached the verb "omits" through the back door.

Petitioner does not subscribe to the highly technical argument of respondent as to the all importance of the use of the term of "gross income" in Section 275(c). Nor does petitioner believe that Congress was concerned with "orthodox" concepts of gross income

and involved syllogisms. The intended coverage of the statute and the meaning of the phrase "omits from gross income" used therein is ascertainable by taking a direct approach.

The usual meaning of the verb in the phrase is "to leave out". The various congressional committee reports and the transcript of the hearing before the House Committee clearly cite examples of the types of errors that Congress believed entitled the Commissioner to an extended period for assessment. Nowhere in the legislative history can there be found indications that Congress intended for the extended statute to apply to mathematical understatements of gross income resulting solely from overstated cost figures.

With regard to his conclusion that overstatements of cost result in omissions, the respondent states as follows (Resp. Br. 18):

> "This is the plain meaning of the statute, and the pertinent committee reports hardly suggest—much less compel—a contrary construction".

Petitioner submits that the committee reports effectively speak for themselves as to the scope of Section 275(c). To petitioner, and the Courts of Appeal for the Third Circuit,[1] Ninth Circuit,[2] Fifth Circuit,[3] and Eighth Circuit,[4] the legislative history conclusively shows that Congress intended for the statute

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[1] *Uptegrove Lumber Co.* v. *Commissioner* (C. A. 3rd, 1953), 204 F. 2d 570; *Deakman-Wells Co.* v. *Commissioner* (C. A. 3rd, 1954), 213 F. 2d 894.

[2] *Slaff* v. *Commissioner* (C. A. 9th, 1955), 220 F. 2d 65.

[3] *Davis* v. *Hightower* (C. A. 5th, 1956), 230 F. 2d 549.

[4] *Goodenow* v. *Commissioner* (C. A. 8th, 1956), 238 F. 2d 20.

to mean what it says—and understatements of gross income resulting from reported overstatements are not "omissions".[5]

On page 22 of his brief respondent again argues that the committee reports make it evident that Congress intended for understatements of gross income to be considered as "omissions" from gross income. Respondent then states as follows (Resp. Br. 22):

> "There is not one reference to a 'failure to disclose' or a 'leaving out' of items of gross proceeds or gross receipts."

This statement is inaccurate. In his own brief respondent refers to the example cited in the committee reports of "a taxpayer (who) failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital". Dividends are items of receipt which are properly includible in a taxpayer's computation of gross income. The omission of such items of receipt from the computation of gross income was precisely the type of error to which the statute was addressed.

Respondent concludes his argument under this section of his brief with the assertion that Congress understood, in enacting Section 6501(e)(1)(A) of the 1954 Code, that it was making changes in the existing law, and that it was re-defining the term gross income to mean total receipts.

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[5]Also see *Lazarus* v. *United States* (Ct. Cls., 1956), 142 F. Supp. 897.

In subsection (A) of Section 6501(e)(1), entitled *General Rule* (and relating to Income Taxes), Congress re-enacted the same language contained in Section 275(c) of the 1939 Code, as follows:

> "(A) *General Rule*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment at any time within 6 years after the return was filed.[6] . . . ."

After re-enacting the substantive provisions of Section 275(c) Congress, by way of addendum, inserted the following language:

> "For purposes of this subparagraph—(subparagraph (A) above)
>
> "(i) In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> "(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return,

[6]Two changes, not herein material, were made when Congress re-enacted this sentence from Section 275(c). In the predecessor provision, "per cent" of in the 1954 Code was expressed as "per centum", and the period for assessment was 5 years instead of 6 years.

in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item."

Obviously the general purpose of subsection (i) was to prevent future controversies as to the applicability of the extended limitation period in "cost of goods sold" cases. Congress clearly indicated its approval of the construction of Section 275(c) enunciated in *Uptegrove Lumber Co.* v. *Commissioner* (C. A. 3rd, 1953), 204 F. 2d 570, and chose to express its approval by the language inserted as subsection (i). Likewise, Congress in adding subsection (ii), approved of the interpretation of Section 275(c) enunciated in *Deakman-Wells Co.* v. *Commissioner* (C. A. 3rd, 1954), 213 F. 2d 894, an "adequacy of disclosure" case.

Section 6501(e)(1)(A) contains additional language, and to that extent changes were made. The substantive language was re-enacted, however, and the changes were purely to approve, explain, clarify and clearly adopt the proper construction of the predecessor statute. Cf. *Davis* v. *Hightower* (C. A. 5th, 1956), 230 F. 2d 549.

C. *The Decided Cases* (Resp. Br., pp. 24-33):

In the concluding section of his brief respondent apparently attempts to convey the impression that all of the courts prior to *Uptegrove* focused attention primarily upon the term "gross income" in the statute, and as a result thereof, concluded that all understatements of gross income were automatically omissions from gross income within the meaning of Section 275(c).

Respondent reads too much from the cases.

Admittedly the Tax Court and the Court of Appeals for the Sixth Circuit have held that overstatements of cost of goods sold result in omissions from gross income. It is questionable, however, as to whether the courts based their decisions on the reasoning espoused by respondent in his brief herein (or in the reasoning respondent attributes to the courts in his brief). Certainly the cited decisions of the Courts of Appeal for the Fifth Circuit and Second Circuit did not employ such reasoning.

The cases of *Foster's Estate* v. *Commissioner* (C. A. 5th, 1942), 131 F. 2d 405 and *Ketcham* v. *Commissioner* (C. A. 2d, 1944), 142 F. 2d 996 are so called "adequacy of disclosure" cases. The issue presented was whether the taxpayer had sufficiently disclosed in his return items of alleged non-taxable receipts. In these early decisions, the courts felt that the Commissioner should not be required to search throughout a return for the disclosure of items of receipt. Accordingly, the courts held that unless the receipts were sufficiently disclosed in the gross income section of the return, the taxpayer "omitted" from gross income amounts properly includible therein. Such cases are clearly distinguishable from the facts in the instant case where the respondent urges that an error in the form of an overstated "offset" or "subtrahend" item is an omission from gross income.

The case of *O'Bryan* v. *Commissioner* (C. A. 9th, 1945), 148 F. 2d 456, also seems to be an "adequacy of disclosure" case. In a later decision the Ninth Circuit so held. *Slaff* v. *Commissioner* (C. A. 9th, 1955), 220 F. 2d 65.

The case of *Carew* v. *Commissioner* (C. A. 6th, 1954), 215 F. 2d 58, is not in point. Therein the taxpayer "left out" a receipt of capital gain in an amount clearly in excess of 25% of the gross income stated in the return. The Sixth Circuit itself found the case distinguishable from *Uptegrove Lumber Co., supra.*

CONCLUSION.

Petitioner submits that respondent's arguments are overly technical and fragile. To petitioner's knowledge, a major portion thereof has never been advanced heretofore by respondent in any court. Respondent has refused to meet the issue squarely, perhaps because of the logically reasoned cases exemplified by *Uptegrove Lumber Co., supra.*

For the foregoing reasons, and the reasons set forth by petitioner in its opening brief, it is respectfully submitted that the judgment of the Court of Appeals for the Sixth Circuit should be reversed.

S. L. GREENEBAUM,
B. H. BARNETT,
CHARLES F. WOOD,
A. ROBERT DOLL,
Attorneys for Petitioner.

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No. 306

In the Supreme Court of the United States

OCTOBER TERM, 1957

THE COLONY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
ROBERT N. ANDERSON,
GRANT W. WIPRUD,
Attorneys,
Department of Justice, Washington 25, D. C.

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MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 15–16) is reported at 244 F. 2d 75. The opinion of the Tax Court (Pet. 17–46) is reported at 26 T. C. 30.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1957 (Pet. 15.) The petition for a writ of certiorari was filed on July 22, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Is the five-year period of limitations provided by Section 275 (c) of the Internal Revenue Code of 1939 applicable where the understatement of gross income

by more than 25 per cent results from an overstatement of the basis of the property sold?

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

* * * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * *

(26 U. S. C. 1952 ed., Sec. 275.)

STATEMENT

The material facts are not in dispute. As found by the Tax Court (Pet. 19–33), they may be summarized as follows:

Taxpayer is a corporation dealing in real estate. (Pet. 19.) In 1945 taxpayer acquired certain land for the purpose of subdivision and sale. It sold lots from this property in the taxable years ended October 31, 1946, 1947 and 1950. In computing its gain from these sales for tax purposes, taxpayer used a cost basis which included certain items of alleged development expense which the Commissioner thereafter determined were not properly includible. The principal item disallowed was the expense of constructing a

water supply system, which totaled more than $33,000. (Pet. 24–25.) The Tax Court sustained the Commissioner as to this item, and variously excluded or reinstated certain other items which the Commissioner had excluded from basis. In sum, the Tax Court found that the total amount of development costs includible in taxpayer's basis for the lots in question was $53,702.09, rather than $93,074.61, the figure which taxpayer had included in the basis as estimated development expense in its returns for the tax years ended October 31, 1946, 1947 and 1950. (Pet. 29–32.)

Under these findings of the Tax Court, taxpayer had understated its gross income for the tax years ended October 31, 1946, and 1947 by more than 25 per cent. The deficiency notices for these tax years were mailed within the extended period provided in waivers which taxpayer executed more than three years but less than five years after the returns were filed. (Pet. 32–33.) The Tax Court held that the five-year period of limitations contained in Section 275 (c) of the Internal Revenue Code of 1939 was applicable, and that the assessment of the deficiencies for the years 1946 and 1947 was not barred. (Pet. 45–46.) The Court of Appeals, in a *per curiam* opinion, affirmed. (Pet. 15–16.)

DISCUSSION

1. Section 275 (c) of the 1939 Code, *supra*, p. 2, provides a five-year[1] period of limitations within which the Commissioner may assess a tax, or commence a proceeding in court for the collection of such

[1] The general period of limitations is three years. 26 U. S. C. 275 (a).

tax, where, for the tax year involved, the "taxpayer *omits from gross income* an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return * * *." (Italics supplied.) "Gross income" is defined in Section 22 (a) of the 1939 Code (26 U. S. C. 1952 ed., Sec. 22 (a)) to include "gains, profits, and income derived from * * * sales or dealings in property, whether real or personal" and "gains or profits and income derived from any source whatever." It is the Commissioner's position that the language of Section 275 (c) is clear and unambiguous, and that this section is applicable in terms whenever a taxpayer understates "gross income" by more than 25 per cent.

The case at bar involves income from the sale of lots. Gains from the sale of realty are, of course, includible in "gross income" as defined by Section 22 (a). But it is not the gross proceeds which are includible. Section 111 (a) of the 1939 Code (26 U. S. C. 1952 ed., Sec. 111 (a)) provides that when "gain" is derived from the sale of property, it shall be the excess of the amount realized therefrom over the basis of the property as determined under Section 113 (26 U. S. C. 1952 ed., Sec. 113). Thus, it is only the gross proceeds *less* the basis which constitute "gain" and which are includible as such in "gross income." It follows that where, as in the case at bar, a taxpayer overstates basis by more than 25 per cent in reporting gains from the sale of property, the result is an understatement of "gross income" by more than 25 per cent, and the requirements of Section 275 (c) are met.

The Tax Court has accepted the Commissioner's contention that the five-year period of limitations of

Section 275 (c) is applicable in these circumstances. *Estate of J. W. Gibbs, Sr.*, 21 T. C. 443; *John E. Goodenow*, 25 T. C. 1. The Sixth Circuit reached this same result in *Reis* v. *Commisisoner*, 142 F. 2d 900, and has now followed that decision in the case at bar. We believe that this line of authority is sound.

2. However, as expressly noted in the Sixth Circuit's opinion herein (Pet. 16), there are conflicting decisions in other circuits. In *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, and *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, the Third Circuit has taken the position that Section 275 (c) does not apply, even though "gross income" be understated by more than 25 per cent, if such understatement results from overstatement of the cost of goods (or basis of property) sold. In effect, these decisions hold that under Section 275 (c) the language "omits from gross income" refers to a failure to report gross receipts. More particularly, the Third Circuit takes the view (which we believe is erroneous) that the Congressional purpose in enacting Section 275 (c) was to confine the statute to situations where taxpayers have failed to make a full disclosure, somewhere in their returns, of the fact and amount of gross receipts.

This view that Section 275 (c) does not apply where there is full disclosure of gross receipts, somewhere in a taxpayer's return, has been adopted and applied by other courts to reach results which are in conflict, directly or in principle, with the Sixth Circuit's decisions in *Reis* and in the case at bar. *Goodenow* v. *Commissioner*, 238 F. 2d 20 (C. A. 8th); *Slaff* v.

Commissioner, 220 F. 2d 65 (C. A. 9th); *Davis* v. *Hightower*, 230 F. 2d 549 (C. A. 5th); *Lazarus* v. *United States*, 142 F. Supp. 897 (C. Cls.).

3. The Internal Revenue Code of 1954 has rendered moot, as to tax years covered by the new Code, the questions here presented. (See Section 6501 (e) (1) (A) (26 U. S. C. 1952 ed., Supp. II, Sec. 6501 (e)). But Section 275 (c) remains the governing statute for two tax years (1952 and 1953) which are still open or for which many cases are now pending. In the Tax Court alone, 121 cases involving $4,948,000 are still pending which require interpretation of the language, "omits from gross income," as used in Section 275 (c). There are also pending in the Internal Revenue Service 69 contested claims (involving $3,750,000) which present the same question, and many of these will doubtless reach the courts. It appears, therefore, that the issue presented as to the proper scope of Section 275 (c) remains one of substantial importance in the administration of the income tax laws.

CONCLUSION

For the reasons stated, the Government does not oppose the granting of certiorari.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
ROBERT N. ANDERSON,
GRANT W. WIPRUD,
Attorneys.

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from the total sales proceeds, is the amount properly includible in gross income; if it is understated, for whatever reason, by more than 25% of the amount of gross income stated in the return, Section 275 (c) is plainly applicable.

Nor is there any warrant in the legislative history for a contrary construction of the statute. The pertinent committee reports are focused upon gross income, and make it clear that understatements thereof, however occasioned, and whether due to negligence or to an honest mistake of law, are within the purview of the statute.

Moreover, for many years the courts unanimously applied this construction of the statute. Between 1941 and 1953 the Courts of Appeals for the Second, Fifth, Sixth and Ninth Circuits and the Tax Court consistently interpreted and applied the statute as relating to Section 22 (a) gross income. However, in 1953 the Third Circuit departed from this settled line of authority, holding in substance that omission from gross income within the meaning of Section 275 (c) means failure to report gross receipts. Since then the Fifth and Ninth Circuits have espoused the latter view, and the Eighth Circuit and Court of Claims have also taken this position, with various modifications.

The Sixth Circuit and the Tax Court, however, have continued to adhere to the view that the statute applies to Section 22 (a) gross income, which is also the view of the Second Circuit as reflected in its single decision on the subject. The Government believes that this is the correct interpretation, and, indeed, the

only interpretation consistent with the plain language of the statute and its legislative history. Hence the understatements of gross income in this case are within the purview of Section 275 (c), and the Commissioner's notices of deficiency were timely under the applicable five-year period of limitations.

ARGUMENT

THE COURTS BELOW CORRECTLY HELD THAT THE FIVE-YEAR STATUTE OF LIMITATIONS WITH RESPECT TO DEFICIENCY ASSESSMENTS WAS APPLICABLE BECAUSE TAXPAYER UNDERSTATED BY MORE THAN 25 PERCENT THE AMOUNT REPORTED AS GROSS INCOME IN ITS RETURNS

A. PRELIMINARY

The single issue in this case concerns the applicability of the five-year statute of limitations with respect to deficiency assessments provided in Section 275 (c) of the Internal Revenue Code of 1939, *supra*, pp. 3–4. In enacting Section 275 (c), Congress was dealing exclusively with civil tax liability. Moreover, when this section was enacted, as we shall demonstrate *infra*, pp. 18–20, provision had already been made in the revenue laws for an unlimited period within which to assess civil tax liabilities, both where taxpayers had wilfully filed false returns and where taxpayers, wilfully or unwilfully, had filed no returns. In all other cases, the Commissioner had three years from the filing of a return within which to assess deficiencies, regardless of the nature or extent of the errors in the return. Weighing against the desirability of an early termination of disputes the desirability of having each taxpayer bear his proportionate share of the

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In the Supreme Court of the United States

OCTOBER TERM, 1957

THE COLONY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOSEPH F. GOETTEN,
GRANT W. WIPRUD,
Attorneys,
Department of Justice, Washington 25, D. C.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3–26) are reported at 26 T. C. 30. The opinion of the Court of Appeals (R. 42–43) is reported at 244 F. 2d 75.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1957. (R. 42.) The petition for a writ of certiorari was filed on July 22, 1957, and was granted on October 14, 1957. (R. 43.) The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTION PRESENTED

In determining whether the Commissioner is entitled to the benefit of the five-year statute of limita-

tions with respect to deficiency assessments provided in Section 275 (c) of the Internal Revenue Code of 1939, the question is:

Where gain from the sale of property is understated by more than 25% of the amount reported as gross income in the return, does such understatement of gain constitute an omission "from gross income [of] an amount properly includible therein," notwithstanding that it results from subtracting an excessive cost basis rather than from understating the total proceeds of sale?

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property

shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(26 U. S. C. 1952 ed., Sec. 111.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a) adjusted as hereinafter provided.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess

of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 275.)

SEC. 276. SAME—EXCEPTIONS.

(a) *False Return or No Return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

* * * * *

(26 U. S. C. 1952 ed., Sec. 276.)

STATEMENT

The material facts, as found by the Tax Court (R. 3, 7–15) and as reflected in taxpayer's returns for the years in question (R. 27–41), may be summarized as follows:

Taxpayer is a Kentucky corporation organized in 1945. Shortly after incorporation, taxpayer acquired a farm of approximately 228 acres near Lexington, Kentucky, for the purpose of subdivision into residential lots. Taxpayer's principal business thereafter was the development and sale of such lots to individual buyers. It sold some of these lots in each of its fiscal years ended October 31, 1946, 1947 and 1950. (R. 3, 7–8.)

An account entitled "Reserve for Improvements" was set up on taxpayer's books and credited on Sep-

tember 30, 1946, in the amount of $93,074.61. This amount represented taxpayer's estimate of the costs which would be incurred in the development of the subdivision. The reserve account was debited in the amount of each expenditure which taxpayer considered an expense of development for the subdivision. As of September 30, 1950, the total amount debited to the account was $87,483.79, leaving a credit balance of $5,590.82. The total amount debited to the reserve account consisted of the following entries: (1) $33,781.70, the cost of a water supply system; (2) $8,713.54, the total of payments to utility companies; and (3) $44,988.55 for other expenditures not here in issue. (R. 12.)

For the purpose of computing and reporting gain from the sale of the lots sold in 1946, 1947 and 1950, taxpayer included as part of the basis of the lots a proportionate part of $93,074.61, the amount originally estimated for development costs and credited to the reserve account. The total basis claimed by taxpayer for the subdivision, including the estimated development costs, was $131,550. (R. 8, 12.)

In its income and declared value excess-profits tax return for the fiscal year ended October 31, 1946, taxpayer reported "Total income" of $22,250.03. (R. 27.) Taxpayer arrived at this figure, as shown by schedule A submitted with that return (R. 32), in the following manner:

Sales of 29 lots "The Colony Subdivision"	$78,987.50	
Less Cost of Lots Sold	57,375.00	
Profit on Lot Sales		21,612.50
Sales of Farm Products		637.53
Total Gross Revenue		$22,250.03

In its income tax return for the fiscal year ended October 31, 1947, taxpayer reported "Total income" of $18,095.41. (R. 36.) Taxpayer arrived at this figure, as revealed by Schedule A submitted with the return (R. 38), in the following manner:

Gross Profit—Farm		$8,595.41
Sales of 9 Lots	$28,075.00	
Less Cost of Lots Sold	18,575.00	
Gross Profits—Lots		9,500.00
Total Gross Revenue		18,095.41

On audit of these returns (and the subsequent return for the year ended October 31, 1950) the Commissioner determined that the total amount of development costs includible in the basis of the lots did not exceed $44,988.55, and therefore that the total basis of the subdivision did not exceed $83,463.94. The Commissioner reached this determination by disallowing the following items of claimed development expense: (1) That portion of the original estimated cost of development which taxpayer had not expended as of September 30, 1950 ($5,590.82); (2) taxpayer's expenditures to acquire a water supply system ($33,781.70); and (3) taxpayer's payments to the utility companies ($8,713.54). (R. 8.) The total over-statement of basis thus determined by the Commissioner was allocated to the lots sold each year in the further determination of deficiencies for the fiscal years ended October 31, 1946, 1947 and 1950. (R. 12–14).

The deficiency notices for the tax years ended October 31, 1946, and 1947, were mailed within the ex-

tended periods provided in waivers which taxpayer executed more than three years but less than five years after the returns were filed. (R. 15.)

The Tax Court agreed with the Commissioner in disallowing as items of development cost the cost of the water supply system and the credit balance of the estimated development cost, but found that the amounts paid to utility companies were properly includible in basis. (R. 19–25.)[1] Having thus disallowed $39,372.52 of the claimed development cost, the Tax Court found that the total basis of the subdivision did not exceed $92,177.48, or 70.07% of the basis claimed. More particularly, the Tax Court found that the basis of the lots sold in the year ended October 31, 1946, was $40,202.66 (rather than $57,375 as reported by taxpayer), and in the year ended October 31, 1947, was $13,015.50 (rather than $18,575 as reported by taxpayer). As a necessary corollary to these overstatements of basis, the Tax Court further found that taxpayer had understated its gross income for the year ended October 31, 1946, by $17,172.34 (77.2% of the amount reported as gross income), and had understated its gross income for the year ended October 31, 1947, by $5,559.50 (30.7% of the amount reported as gross income). (R. 14–15.)

The Tax Court found as an ultimate fact that, in its returns for each of the years ended October 31, 1946, and October 31, 1947, taxpayer omitted from

[1] Since taxpayer does not dispute the Tax Court's disallowance of claimed items of development cost, it is unnecessary to summarize the Tax Court's detailed findings (R. 8–11) with respect to those items.

gross income an amount properly includible therein which was in excess of 25% of the amount of gross income stated in the returns. (R. 15.)

On the basis of these findings, the Tax Court held that the 5-year period of limitations in Section 275 (c) is applicable, and that the deficiencies for the years 1946 and 1947 were therefore not barred by the statute of limitations. (R. 26.) The Court of Appeals affirmed in a *per curiam* opinion. (R. 42–43.)

SUMMARY OF ARGUMENT

Congress enacted Section 275 (c) of the Internal Revenue Code of 1939 to provide a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large. It described the type of error with which it was concerned as an omission from "gross income [of] an amount properly includible therein," and provided for measurement of such errors in terms of a percentage of the amount of "gross income stated in the return." The interrelationship of the error description and standard of measurement provisions makes it clear that Congress meant that a failure to state an amount as gross income anywhere in the return would constitute an omission of that amount from gross income. In enacting Section 275 (c), Congress was as concerned with honest errors as it was with dishonest errors; for purposes of that section, if an amount is omitted from gross income which is properly includible therein, it is immaterial that the amount may be disclosed elsewhere in the return in

some form other than as gross income, as, for example, a return of capital invested.

It is undisputed here that taxpayer understated the amount reported as gross income for the tax years involved by more than 25%, owing to an overstatement of the basis of realty sold during those years. The Commissioner's notices of deficiency were mailed within the extended period provided in waivers which taxpayer executed more than three years, but less than five years, after the returns were filed. The narrow question presented here is whether taxpayer's understatements of gain from sales constituted omissions from gross income within the meaning of Section 275 (c) of the 1939 Code, which provides a five-year period of limitations for the assessment and collection of deficiencies.

We submit that the terms of Section 275 (c) are clear and unambiguous, and apply precisely to the case at bar. They provide for a five-year period of limitations where there is omitted from gross income an amount properly includible therein exceeding 25% of the amount of gross income stated in the return. Amounts properly includible in gross income must be determined by reference to Section 22 (a), which defines gross income for the purposes of the income tax laws, and specifically enumerates gains from sales as properly includible items. Under Section 111 (a) the gain from the sale of property is the excess of the amount realized therefrom (total sales proceeds) over the adjusted basis (essentially cost, see Section 113, *supra*, p. 3) of the property. Hence, the amount of gain from the sale of property, as distinguished

tax burden, Congress in enacting Section 275 (c) decided to provide for a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large. If a taxpayer reported an income of $99,000 when he should have reported $100,000, the error of $1,000 might be relatively small. If another taxpayer reported an income of $4,000 when he should have reported $5,000, the error, although in the same amount, would be relatively large. Accordingly, if the longer period of limitations was to apply exclusively to relatively large errors it was necessary to measure the error in relation to the amount of income reported. Congress undoubtedly could have chosen to express the error in terms of an omission from "net income" and to have measured the error in terms of a percentage of the "net income" reported. This, however, for whatever reason,[2] it did not do. Congress rather chose to express the error in terms of an omission from "gross income of an amount properly includible therein," and to measure the error in terms of a percentage "of the amount of gross income stated in the return."

In the light of this general background, we would at the outset emphasize two observations before proceeding to a detailed consideration of the statutory language and its construction. First, Congress was primarily concerned with the relative size of the error in the return adversely affecting the revenue,

[2] To attempt, in the absence of any reliable indication in the legislative history, to ascribe to Congress a reason for not using the term "net income"—or, for that matter, to have addressed itself to understatements of the tax itself—in Section 275 (c) would be pure speculation.

and there is, accordingly, an essential correlation between its description of that error and its expression of the standard for measuring it. The standard is expressed in terms of a percentage of the amount of gross income stated in the return. Since the return contains no single item entitled "gross income," the amount of gross income stated in the return must necessarily be the sum of the items stated in the various parts of the return as gross income. It would seem logically to follow that a taxpayer has omitted from gross income an amount properly includible therein when he has understated that amount, or failed to state it at all as gross income in any of the various parts of the return. Secondly, in enacting Section 275 (c) Congress was concerned with results, not causes; with relatively large mistakes, not whether they were honest or dishonest; and, for example, with whether the amount of a dividend was reflected in a return as gross income, not whether or not it may have been disclosed but erroneously shown as affecting only the stock's basis because it was paid out of capital. It would also seem to follow, therefore, in the absence of any indication to the contrary, that in enacting this legislation Congress intended to cover the situation where a taxpayer failed to state an amount of gain from the sale of property as gross income anywhere in his return, regardless of whether he disclosed the amount but erroneously showed it as a return of his capital investment in the property.

In its tax returns for the years ended October 31, 1946, and October 31, 1947, taxpayer reported as part of its gross income certain gains from the sale of real

estate. The Tax Court found that taxpayer had substantially overstated the basis of the realty in computing the gains from sales, and hence had understated both the gains and the total gross income reported by more than 25%. Further, the Tax Court rejected the taxpayer's contention that assessment and collection of deficiencies were barred by the statute of limitations, holding that the Commissioner's deficiency notices were timely under the five-year period of limitations provided by Section 275 (c) of the 1939 Code.

In this Court, as in the Court of Appeals, taxpayer does not dispute the Tax Court's finding that the amount taxpayer reported as gross income for the years in question was understated by more than 25%. Nor does taxpayer deny that the Commissioner's deficiency notices were timely if Section 275 (c) is applicable. But taxpayer renews here its contention that Section 275 (c) is inapplicable; that the general three-year period of limitations provided by Section 275 (a), *supra*, p. 3, is controlling; and therefore that collection of the deficiencies is barred, the deficiency notices having been mailed within the extended period provided in waivers executed by the taxpayer more than three years after the returns were filed.

The narrow question,[3] then, is whether Section 275 (c) applies to an understatement of gross income by more than 25%, resulting from an overstatement of

[3] This question should be considered in the light of the statement in *Dupont de Nemours & Co.* v. *Davis*, 264 U. S. 456, 462: "Statutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government."

basis and corresponding understatement of gains from sales of realty. As we shall now demonstrate, the plain language of the statute, its legislative history, and the more soundly-reasoned line of judicial decisions compel an affirmative answer to this question.

B. THE STATUTE AND ITS LEGISLATIVE HISTORY

Section 275 (c) provides in pertinent part:

> If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, * * * at any time within 5 years after the return was filed.

There is obviously nothing in the statute to indicate that the term "gross income" is used in any special or limited sense. It is appropriate, then, to refer to the general definition of "gross income" for purposes of the income tax laws, as set forth in Section 22 (a) of the 1939 Code, *supra*, p. 2. That definition embraces, *inter alia*, "*gains * * * derived from * * * sales * * **." (Italics supplied.) In turn, "gain from the sale" of property is defined by Section 111 (a) of the 1939 Code, *supra*, pp. 2–3, as the excess of the amount realized from the sale (total sales proceeds) over the adjusted basis (essentially cost) of the property as determined under Section 113. Thus it is clear that the total sales of property do not constitute "gross income" for purposes of the income tax laws. It is only the excess of such proceeds over the cost basis which constitutes "gain from the sale" under Section 111 (a), and which as such is therefore prop-

erly includible in "gross income" as defined by Section 22 (a).

Section 275 (c) by its terms applies to an omission from "gross income" of "an amount properly includible therein." Total proceeds of sales are not properly includible; gains from sales are. It follows that where a taxpayer includes gains from sales in reported gross income, and such gains are understated, the taxpayer "omits from gross income an amount properly includible therein," i. e., the amount of the understatement. It is immaterial whether the understatement is occasioned by an understatement of total sales proceeds or an overstatement of cost basis.

This conclusion is confirmed by other language in Section 275 (c). The term "gross income" is used twice in that section, first in the opening phrase with respect to omissions of amounts properly includible, discussed above, and second, in the ensuing phrase which provides that the omissions must exceed 25% "of the amount of gross income stated in the return * * *." Here again the orthodox concept of gross income set forth in Section 22 (a) is surely applicable. The return form does not call for a single figure entitled "gross income"; it rather includes, for the various types of income enumerated in Section 22 (a), separate schedules in each of which an amount is stated as gross income of a particular type. It is the sum of these amounts stated as gross income of various types that constitutes "the amount of gross income stated in the return." Amounts of income shown in the various schedules are carried forward

as "Total income" on the face of the return. Thus, taxpayer's return for its fiscal year ended October 31, 1946, shows on its face a total income figure of $22,250.03—and, indeed, shows no other figure, reference being made to an attached schedule for the computation. (R. 27.) When the schedule (R. 32) is consulted, it reveals that the figure of $22,250.03, carried to the face of the return, is stated in the schedule as "Total Gross Revenue," and insofar as the sales of lots are concerned, quite properly includes only the gain from such sales as distinguished from the total sales proceeds. To deny that this figure stated as total gross revenue is the "gross income stated in the return" is to deny the clear meaning of that language and the obvious intent of Congress.

It is questionable, moreover, whether taxpayer does deny this. As noted above, taxpayer does not challenge the Tax Court's finding that its gross income for the years involved was understated by more than 25%. That finding relates to an understatement of the amounts stated as total gross revenue in taxpayer's returns, and in accepting the finding taxpayer is clearly accepting the ordinary and usual meaning of the language, "gross income stated in the return * * *." Yet taxpayer contends that the term "gross income" has quite another meaning in the opening phrase of Section 275 (c), i. e., "omits from gross income an amount properly includible therein * * *." As used in that phrase, taxpayer contends, in substance, the term "gross income" means "gross receipts reported somewhere in the return," even though such gross

receipts are not "properly includible in gross income." We submit that the clear and unambiguous language of the statute affords no basis whatever for such an interpretation but, rather, compels the conclusion that Congress intended to deal with omissions from "gross income" in the usual and accepted sense of that term, as defined by Section 22 (a). Hence any understatement of "gain" from the sales of property—whether it results from an understatement of gross proceeds or an overstatement of basis—necessarily results in an omission from "gross income" within the meaning of Section 275 (c).

This is the plain meaning of the statute, and the pertinent committee reports hardly suggest—much less compel—a contrary construction. The provisions of Subsection (c) of Section 275 first appeared in Section 275 (c) of the Revenue Act of 1934, c. 277, 48 Stat. 680. The bill originating in the House would have amended Section 276 of the Revenue Act of 1932, c. 209, 47 Stat. 169, relating to no returns or fraudulent returns, and would have made inapplicable any statute of limitations on assessments where taxpayers understated their gross income by a large amount. The reason for the provisions was stated in a subcommittee report published as part of the House Hearings on the Revenue Revision of 1934, p. 139, as follows:

> Section 276 provides for the assessment of the tax without regard to the statute of limitation in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax.

> Your subcommittee is of the opinion that the limitation period on assessments should also not apply to certain cases where the taxpayer *has understated his gross income* on his return by a large amount, even though fraud with intent to evade tax cannot be established. It is, therefore, recommended that the statute of limitations shall not apply where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized when a taxpayer is so negligent as to leave out items of such magnitude from his return. [Italics supplied.]

The full Committee adopted this reasoning as part of its report, published in H. Rep. No. 704, 73d Cong., 2d Sess., p. 35 (1939–1 Cum. Bull. (Part 2) 554, 580), as follows:

> Section 276 (a). No return or false return: The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The change in this section continues this policy, but enlarges the scope of this provision to include cases wherein the taxpayer *understates gross income* on his return by an amount which is in excess of 25 percent of the gross income stated in the return. It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute. [Italics supplied.]

The Finance Committee of the Senate incorporated this language in Section 275, except that it provided for a five-year period of limitations. It was this provision that was finally enacted into law. In its report (S. Rep. No. 558, 73d Cong., 2d Sess., pp. 43–44 (1939–1 Cum. Bull. (Part 2) 586, 619)) the Committee said:

> The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The House bill continues this policy, but enlarges the scope of of this provision to include cases wherein the taxpayer *understates gross income* on his return by an amount which is in excess of 25 percent of the gross income stated in the return. Your committee is in general accord with the policy expressed in this section of the House bill. However, it is believed that in the case of a taxpayer who makes an *honest mistake,* it would be unfair to keep the statute open indefinitely. *For instance, a case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital* or he might report as income for one year an item of income which properly belonged in another year. Accordingly, your committee has provided for a 5-year statute in such cases. * * * [Italics supplied.]

It is clear from the above reports, as it is from the plain language of the statute, that the Congressional intent was to fix a longer period of limitations where gross income is understated by more than 25% of the

amount actually stated in the return. Taxpayer attempts to minimize the explicit references to understatement of gross income which we have italicized above, by contending (Br. 16): "Immediately following each such reference is a specific restrictive statement or illustration of a 'failure to disclose' income or 'leaving out' items of receipt." What taxpayer fails to point out, however, is that the specific statements or illustrations also allude only to gross income, not receipts. Let us examine the allegedly "restrictive" statements or illustrations in the committee reports, particularly those with respect to "failure to disclose" or "leaving out." The House subcommittee report, first quoted above, speaks of situations "where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return." The full committee report of the House, quoted above, speaks of situations "wherein the taxpayer understates gross income on his return by an amount which is in excess of 25 percent of the gross income stated in the return." Taxpayer does not quote that part of the committee report, but only the ensuing sentence (Br. 16), "It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute." Obviously, in view of the preceding sentence, the full committee was speaking of taxpayers who "leave out" of their returns "items" of gross income. Finally, there is the Senate report, quoted above, which again speaks of "cases wherein the taxpayer understates gross income on his return

by an amount which is in excess of 25 percent of the gross income stated in the return." This report goes on to state that the new provision is intended to cover "an honest mistake," and gives as examples cases where "a taxpayer failed to report a dividend" because of erroneous advice that it was a return of capital, or where "he might report as income for one year an item of income which properly belonged in another year.[4]

The reports thus make it evident that Congress was concerned with omissions from "gross income" exceeding 25% of the "gross income stated in the return," and that understatements of gross income constituted such omissions in the view of the committees. There is not one reference to a "failure to disclose" or a "leaving out" of items of gross proceeds or gross receipts. There are only references, as demonstrated above, to a failure to disclose gross income; to a leaving out of items of gross income; and, finally, to a failure to report a dividend, which is obviously part of a distributee's gross income if it is not a return of capital.

Taxpayer relies (Br. 15) on a colloquy between Congressman Jere Cooper and a Treasury official. We submit, however, that Congressman Cooper's informal remarks need not be interpreted in a manner contrary to the plain language of the statute and

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[4] Since it is immaterial whether or not the omission results from an honest mistake, it cannot avail taxpayer to insist (Br. 10) that it overstated the basis of the property sold "in good faith, but erroneously," and that "*there is no suggestion of fraud, negligence or lack of good faith* in this case." [Taxpayer's italics.]

of the committee reports. Indeed, he too speaks of taxpayers who omit items exceeding 25% of gross income. Moreover, even if the quoted remarks plainly indicated another view, they would certainly have to yield to the provisions of the statute and the explicit views of the full committees.

This brings us to taxpayer's contention (Br. 23–24) that, in enacting Section 6501 (e)(1)(A) of the 1954 Code as the successor provision to Section 275 (c) of the 1939 Code, Congress intended only to clarify existing law. Curiously enough, however, taxpayer does not ground this contention upon the legislative history of the 1954 Code, but upon views expressed by the Fifth Circuit in *Davis* v. *Hightower*, 230 F. 2d 549. Surely Congress itself is the best authority for its own intentions and views, as reflected in the relevant committee reports, which, in substantially identical language, explicitly state as follows (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A414 (3 U. S. C. Cong. & Adm. News (1954) 4017, 4561); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 584 (3 U. S. C. Cong. & Adm. News (1954) 4621, 5233)):

> *Several changes from existing law* have been made in subsection (e) of this section. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term *gross income* as used in this paragraph has been *redefined* to mean the total receipts from the sale of goods or services prior to diminution by the cost of such sales or services. A *further change from existing law* is the provision which states that any amount

> as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent. [Italics supplied.]

Obviously, then, in enacting the 1954 Code, Congress understood that it was making changes in the existing law, and that it was redefining the term gross income to mean total receipts. This confirms, if any confirmation be necessary, that Congress used the term gross income in its orthodox sense in Section 275 (c) of the 1939 Code, and that it meant the statute to apply to all omissions from gross income, so understood, exceeding 25% of the gross income stated in the return. Hence it is clear that the courts below correctly held that Section 275 (c) was applicable to the case at bar.

C. THE DECIDED CASES

Section 275 (c) is applicable in terms to omissions from gross income of all amounts properly includible therein, where such amounts exceed 25% of the amount of gross income stated in a taxpayer's return. In these provisions, as has been demonstrated, the term gross income was obviously used in its usual sense, as defined by Section 22 (a); hence understatements of gross income constitute omissions therefrom, within the meaning of Section 275 (c), whether they result from failure to report items of receipt or, in the case of gains, from overstatements of basis.

The courts had unanimously adopted this view of the statute until a comparatively recent date. In 1941 it was held in *Maloy* v. *Commissioner*, 45 B. T. A.

1104, that the term gross income, as used in Section 275 (c), does not mean gross receipts, but amounts properly includible in gross income as defined by Section 22 (a), and hence that only 50% of certain long-term capital gains were includible in determining whether there had been an understatement of gross income exceeding 25%. The following year, in *Foster's Estate* v. *Commissioner*, 131 F. 2d 405 (C. A. 5th), the court expressly invoked (p. 406) the definition of gross income set forth in Section 22 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, which was the predecessor of Section 22 (a) of the 1939 Code, as the definition applicable to the term "gross income" appearing in the statutory predecessor of Section 275 (c). In 1944 the Second Circuit held in *Ketcham* v. *Commissioner*, 142 F. 2d 996, that Section 275 (c) is not averted by disclosure of gross receipts, since the question is whether there has been omission from gross income of amounts properly includible therein. The court said (p. 997):

> That she [the taxpayer] attached schedules to her returns, stating that she had received certain amounts as trust income in lieu of alimony but that such amount was taxable to her husband, cannot relieve her from the effect of having omitted those amounts from her report of gross income. *Foster's Estate* v. *Commissioner*, 5 Cir., 131 F. 2d 405.

In the same year the Sixth Circuit rendered two pertinent decisions. The first, *Ewald* v. *Commissioner*, 141 F. 2d 750, contained a detailed discussion of the legislative history of Section 275 (c), and

adopted the same construction of the statute. The court said (p. 753): "It is clear that it was the congressional purpose to fix a longer period of limitation regardless of the intention of the taxpayer where the sum omitted from gross income was 25 percent or more." The second decision, *Reis* v. *Commissioner*, 142 F. 2d 900, is squarely in point here, for it involved understatements of gain from sales—and hence of gross income—which resulted from overstatements of basis. The court held that such understatements constituted omissions from gross income within the meaning of Section 275 (c), saying (p. 903):

> The cost basis is fixed by statute. Sec. 111 (a) of the Revenue Acts of 1934 and 1936 * * * provides that the gain from the sale of property shall be the excess of the amount realized therefrom over the basis provided in Sec. 113, and Sec. 113 (a) provides that "the basis of property shall be the cost of such property." It is obvious that petitioner adopted an incorrect basis. * * *
>
> The Court allowed petitioner as a basis the $5,000 which he paid in cash for the property, certain items of taxes and indebtedness which he had assumed, and $35 representing the cost of a locomotive reel which he had purchased and sold in 1935. He added to these amounts an item of $6,463.57. These allowances, so far as they go, are uncontroverted and we find no reason for disturbing them. They aggregate $15,613.95 instead of $78,796.74, the basis allocated by petitioner against the sale of assets. When we ascribe to the word "omits" the meaning given to it in *Ewald* v. *Commissioner*, 6 Cir., 141 F.

> 2d 750, it follows that petitioner failed to include in his returns gross income properly includible in excess of 25% of the amount stated therein, and that the five year limitation period, Sec. 275 (c) of the Revenue Act of 1936, was not a bar.

Accord: *American Liberty Oil Co.* v. *Commissioner*, 1 T. C. 386; *American Foundation Co.* v. *Commissioner*, 2 T. C. 502.

In 1945 the Ninth Circuit decided *O'Bryan* v. *Commissioner*, 148 F. 2d 456. In that case the taxpayer, separated from his wife, prepared his return on the theory that his income was still community property and therefore taxable in equal shares to husband and wife. On the face of his return he stated the total amount of gross receipts from his business, and the expenses thereof, and then stated one-half of the receipts and one-half of the expenses as the figures upon which he computed his total gross income. He also indicated in his return that a separate return was being filed for his wife. The Ninth Circuit held, as had the Second Circuit in *Ketcham*, that the test under Section 275 (c) is whether there has been an omission from *gross income*—not whether there has been an omission of, or failure to include *gross receipts* somewhere in the return. The court said (pp. 459–460):

> The mere appearance of the total amount of gross income somewhere on the face of an income tax return is not sufficient to prevent an omission within the terms of § 275 (c). * * * It is apparent from the pertinent legislative history that care and good faith on the part of of a taxpayer will not prevent the applicability

of subsection (c). *Ewald* v. *Commissioner of Internal Revenue,* 6 Cir., 1944, 141 F. 2d 750, 753. To satisfy the terms of the section, the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure. In the instant case gross income was shown as only half the correct amount. Therefore, the limitation period for assessing deficiencies was determined by § 275 (c). *Ketcham* v. *Commissioner of Internal Revenue,* 2 Cir., 1944, 142 F. 2d 996, 997; *Reis* v. *Commissioner of Internal Revenue,* 6 Cir., 1944, 142 F. 2d 900, 903; *Foster's Estate* v. *Commissioner of Internal Revenue,* 5 Cir., 1942, 131 F. 2d 405, 406.

Thus, by 1945, the Second, Fifth, Sixth, and Ninth Circuits and the Tax Court had held that an omission from gross income, within the meaning of Section 275 (c), does not mean an omission from a return of items of gross receipts, but an omission from gross income as defined by Section 22 (a). As aptly stated by the Ninth Circuit in the above-quoted language from *O'Bryan,* "the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure." Hence, disclosure of gross receipts, whether in a schedule as in *Ketcham* or on the face of a return as in *O'Bryan,* was regarded as immaterial. And it necessarily followed, as held in *Reis,* that an understatement of gains from sales which results from an overstatement of basis is an omission from gross income within the meaning of the statute. See Rich-

ards, *The Extended Statute of Limitations on Assessment*, 12 Tax Law Review 297.

All appellate courts considering the question had adopted this view prior to 1945, and none took a contrary view for eight years thereafter. Indeed, the law seemed so well settled on this point that the Tax Court resorted to memorandum decisions in 1950 and 1951, in holding that understatements of gains from sales resulting from overstatements of basis were within the purview of Section 275 (c). *Owen-Fields Importing Co.* v. *Commissioner*, decided November 17, 1950 (1950 P-H T. C. Memorandum Decisions, par. 50,279); *Ohio Fruit Products Co.* v. *Commissioner*, decided January 31, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,040).

In 1953, despite this long-standing, consistent administrative practice and judicial construction, the Third Circuit, in *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, held that understatements of gross income by a manufacturing corporation, owing to overstatements of the cost basis of goods sold, were not omissions from gross income within the meaning of Section 275 (c). The court reached this conclusion on the theory that omission from gross income, within the meaning of Section 275 (c), meant omission of some item of gross receipt from the computation of gross income. In adopting this theory, the court ignored the rationale of such previous decisions as *Ketcham* and *O'Bryan*, *supra*, preferring to dismiss those cases as factually distinguishable and hence not in point. *Reis* v. *Commissioner*, *supra*, which could not be factually distinguished, was not mentioned.

In substance, *Uptegrove Lumber Co.* stands for the proposition that omission from gross income, within the meaning of Section 275 (c), means nothing more than failure to report gross receipts. Under that construction the additional requirement, that gross receipts must enter into some stage of the computation of gross income, has little substance; a taxpayer need only report his gross receipts and immediately offset them with an overstated basis in order to avert the application of Section 275 (c), as interpreted by the Third Circuit. This construction ignores the definition of gross income set forth in Section 22 (a), and the fact that Section 275 (c) in clear terms applies to omissions from gross income of amounts properly includible therein exceeding 25% of the gross income stated in the return.

In the following year the line of authority from *Ketchum* to *Reis* was followed in *Carew* v. *Commissioner*, 215 F. 2d 58 (C. A. 6th). In that case the taxpayer had included in his statement of the cost of goods sold such improper items as an amount labelled alimony settlement, thereby overstating his cost basis and understating his gross profit. The taxpayer also omitted an item of capital gain from the return. It was held, with respect to the overstatement of the cost of goods sold, that there was an omission from gross income within the meaning of Section 275 (c), even though gross receipts were reported, and even though on the information given the Commissioner could have revised the return. In so ruling the court cited all of the decisions discussed above, quoting (p. 62) from *O'Bryan* the succinct statement that:

"To satisfy the terms of the section, the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure." The Sixth Circuit dismissed the *Uptegrove Lumber Co.* decision as distinguishable upon its facts.

The Third Circuit, however, adhered to its position in *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, stating that Section 275 (c) does not apply where the taxpayer (p. 897) "merely understates the final figure in this gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure." More recently, notwithstanding their earlier decisions, discussed above, the Fifth and Ninth Circuits have accepted this view; indeed, they have apparently gone further than the Third Circuit by requiring only that there be disclosure of gross receipts in the return, and failing to require that the gross receipts enter into the computation of gross income. *Davis* v. *Hightower*, 230 F. 2d 549 (C. A. 5th); *Slaff* v. *Commissioner*, 220 F. 2d 65 (C. A. 9th). The defects in this "disclosure" theory, as we see it, consist in (1) overlooking the fact that Section 275 (c) is aimed at honest mistakes as well as others, and (2) failing to recognize that the significance of disclosure for purposes of that section is disclosure of an amount as "gross income". Similar positions have been taken by the Eighth Circuit in *Goodenow* v. *Commissioner*, 238 F. 2d 20, and the Court of Claims in *Lazarus* v. *United States*, 142 F. Supp. 897. In sum, the Third Circuit's theory has now been adopted, with various

modifications, by three other circuits and the Court of Claims.

The Sixth Circuit, however, has adhered to the older line of authority, not only in *Carew* in 1954 but in the case at bar. The Tax Court has also consistently adhered to this position, in *Estate of Gibbs* v. *Commissioner*, 21 T. C. 443, decided in 1954, in *Goodenow* v. *Commissioner*, 25 T. C. 1, reversed, 238 F. 2d 20 (C. A. 8th), in the case at bar, and most recently, in *Lawrence* v. *Commissioner*, 27 T. C. 713, now pending on appeal in the Ninth Circuit. Moreover, the rationale of the Second Circuit in its *Ketcham* decision, discussed above, is fully in accord with the views of the Sixth Circuit and the Tax Court.

For the reasons given above, we submit that the correct interpretation and application of Section 275 (c) is found in the decisions of the Second and Sixth Circuits and the Tax Court, and in the earlier decisions of the Fifth and Ninth Circuits. In departing from this line of authority and holding, in effect, that the term gross income as used in Section 275 (c) means gross receipts, we submit that the *Uptegrove Lumber Co.* case is in direct conflict with the clear language of the statute and the legislative history. That "gross income" does not embrace the cost of goods sold, even though that cost includes an excess over the prices fixed by O. P. A., is well settled. *Sullenger* v. *Commissioner*, 11 T. C. 1076, appeal dismissed June 6, 1949 (C. A. 5th); *Commissioner* v. *Weisman*, 197 F. 2d 221 (C. A. 1st); *Hofferbert* v. *Anderson Oldsmobile, Inc.*, 197 F. 2d 504 (C. A. 4th); *Commissioner* v. *Guminski*, 198 F. 2d 265 (C. A. 5th);

Jones v. *Herber,* 198 F. 2d 544 (C. A. 10th); *Roybark* v. *United States,* 218 F. 2d 165 (C. A. 9th). The term "gross income" should not be given a different meaning for purposes of Section 275 (c).

Clearly, understatements of gains from the sale of property, whether they result from understatements of gross receipts or overstatements of basis, are understatements of gross income, as defined in Section 22 (a). In the language of Section 275 (c), such understatements are omissions from gross income of amounts properly includible therein, and when—as in the case at bar—they exceed 25% of the gross income stated in the return, the five year period of limitation applies.

CONCLUSION

For the foregoing reasons, the judgment below is correct and should be affirmed.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
JOSEPH F. GOETTEN,
GRANT W. WIPRUD,
Attorneys.

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